Commercial Bank Examination Manual

On June 23, 2025, the Board announced that reputational risk will no longer be a component of examination programs in its supervision of banks.

Division of Supervision and Regulation

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The manual is updated periodically, and is available at https://www.federalreserve.gov/publications/supmanual.htm. For more information on manual updates, please call 202-452-3244.

Table of Contents
Commercial Bank Examination Manual

This general table of contents lists the major section heads for each part of the manual:

SUMMARY OF CHANGES

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the May 2022 supplement.

Section 1000.1

Minor updates were made to section 1000.1, "Examination Strategy and Risk-Focused Examinations." This section includes updated references to

- the handling of confidential supervisory information as set forth in the Board's regulation on *Nonpublic Information Made Available to Supervised Financial Institutions, Governmental Agencies, and Others in Certain Circumstances* (12 CFR pt. 261, subpart C);
- the Board's *Statement Clarifying the Role of Supervisory Guidance* (12 CFR pt. 262, Appendix A); and
- the Federal Reserve System's process for material supervisory determinations and policy statement regarding the Ombuds (SR-20-28/CA-20-14, "Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System").

Section 1001.1

Section 1001.1, "Community Bank Supervision Process," includes revisions to the community bank report of examination and instructions, specifically:

- indicating that a community state member bank's (SMB) risk assessment matrix can be included in the "Management/Risk Management" content heading or the "Confidential" section of the of the report of examination.
- updating a reference to the handling of confidential supervisory information as addressed in the Board's *Nonpublic Information Made Available to Supervised Financial Institutions, Governmental Agencies, and Others in Certain Circumstances* regulation (12 CFR pt. 261, subpart C).
- revising required language about the ability of a community SMB to appeal material supervisory determinations that Federal Reserve examiners include in the report of examination.
- reducing the required text for a footnote in the report of examination about supervisory findings and substituting the text with a hyperlink to the source guidance on the matter, SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings."
- updating a reference to the Board's *Statement Clarifying the Role of Supervisory Guidance* (12 CFR pt. 262, Appendix A).

Section 1002.1

This new section, "Supervision of State Member Banks in the Regional Banking Organization Portfolio," summarizes the Federal Reserve's approach to supervising SMBs that are in the regional banking organization (RBO) portfolio. The RBO supervisory portfolio generally includes domestic holding companies and SMBs with total consolidated assets greater than or equal to $10 billion and less than $100 billion. The section provides information on the following topics related to the supervision of SMBs in the RBO portfolio.

- Examination scope and frequency
- Supervisory planning process
- Continuous monitoring activities
- Coordination of supervisory activities with other regulators
- Completion of examination procedures
- Instructions for the completion of the report of examination
- Information about how the supervision of SMBs in the RBO portfolio differs from the supervision of institutions in the community banking organization portfolio and the large and foreign banking organization supervisory portfolio

Section 1005.1

This section, "Large Institution Supervision Coordinating Committee," was previously titled, "Consolidated Supervision Framework for Large Financial Institutions." Most of the content in the section was eliminated as the information pertained to the supervision of large holding companies, which is addressed in the *Bank Holding Company Supervision Manual.* The revised section provides a reference to the guidance explaining which firms are in the Large Institution Supervision Coordinating Committee or LISCC supervisory portfolio. Furthermore, the section provides a reference to the *Large Institution Supervision Coordinating Committee Program Manual*, which is publicly available and describes key concepts related to the supervisory oversight structure, process, ratings framework, and communication methods for firms in the LISCC supervisory portfolio.

Section 1007.1

This section, "Other Types of Examinations," was revised to include information about the supervision of representative offices of foreign banking organizations (FBOs). U.S. representative offices of FBOs engage in diverse activities ranging from liaison, marketing, and research functions to operational activities such as loan production, administrative, and certain trading functions. For more information on U.S. representative offices of FBOs, see SR-19-15, "Revised Examination Guidelines for Representative Offices of Foreign Banks." Furthermore, the section was revised to include information about supervised insurance organizations. A "supervised insurance organization" is a depository institution holding company that is an insurance underwriting company that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries, or that has been otherwise designated as a supervised insurance organization by Federal Reserve staff. For more information on the Federal Reserve's supervision of these institutions, see SR-22-8, "Framework for the Supervision of Insurance Organizations."

Section 1015.1

This section, "Conflict-of-Interest Rules for Examiners," was revised to provide updated information about special post-employment restrictions for Federal Reserve senior examiners. Most of the information about the administrative procedures for implementing the "senior examiner" restrictions were replaced with a reference to SR-21-13/CA-21-10, "Revised Special Post-Employment Restriction for Senior Examiners and Work Paper Reviews for Departing Examiners," which provides more information on this topic.

Section 1200.1

This section, "Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating," was updated to reflect the Federal Reserve's guidance for boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness." Specifically, the section was revised to better reflect the roles and responsibilities of a supervised institution's board of directors and senior management.

Section 2003.1

This section, "Supervisory Loan Sampling at Regional Banking Organizations," was renamed. The section was previously titled, "Examiner Loan Sampling Requirements for State Member Bank and Credit-Extending Nonbank Subsidiaries of Banking Organizations with \$10–\$50 Billion in Total Consolidated Assets." The section was revised to reflect that the underlying guidance on loan sampling now applies to the supervision of SMB and credit extending nonbank subsidiaries of bank holding companies with greater than or equal to \$10 billion and less than \$100 billion in total consolidated assets. In addition, references to the allowance for credit losses (ACL) replaced references to the allowance for loan and lease losses (ALLL). For more information, see SR-14-4, "Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Bank Holding Companies in the Regional Banking Organization Supervisory Portfolio."

Section 2011.1

This section, “Credit Risk Review Systems,” was updated to remove an outdated SR letter reference. A reference to SR-13-19/CA-13-21, “Guidance on Managing Outsourcing Risk,” was replaced with a reference to SR-23-4, “Interagency Guidance on Third-Party Relationships: Risk Management.”

Section 2013.1

This section, “Allowance for Credit Losses,” was updated to reflect revisions to the “Interagency Policy Statement on Allowances for Credit Losses,” which was issued by the federal banking agencies on April 21, 2023. The “Interagency Policy Statement on Allowances for Credit Losses” was revised to remove references to troubled debt restructurings to conform with U.S. generally accepted accounting principles (GAAP). For additional details, refer to the March 2022 Financial Accounting Standards Board (FASB) issuances of “Accounting Standards Update 2022-02 (ASU 2022-02)” and “Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings (TDRs) and Vintage Disclosures.” ASU 2022-02 eliminated the recognition and measurement accounting guidance for TDRs by creditors upon adoption of FASB Accounting Standards Codification (ASC) Topic 326. For more information, see SR-20-12, “Interagency Policy Statement on Allowances for Credit Losses.”

Section 2110.1

This section, “Floor-Plan Loans,” was updated to remove an outdated SR letter reference. A reference to SR-13-19/CA-13-21, “Guidance on Managing Outsourcing Risk,” was replaced with a reference to SR-23-4, “Interagency Guidance on Third-Party Relationships: Risk Management.”

Section 2142.1

This section, “Agricultural Credit-Risk Management,” was updated to reflect the Federal Reserve’s guidance for a supervised institution’s boards of directors in SR-21-3/CA-21-1, “Supervisory Guidance on Board of Directors’ Effectiveness.” Specifically, the section was revised to better reflect the roles and responsibilities of a supervised institution’s the board of directors and senior management. In addition, the section was revised to include information on assessing risk mitigation strategies of a supervised institution’s borrowers who employ risk mitigation strategies such as commodities derivatives to control the price of feed or feedstock and the sales price for agricultural production or crops.

Sections 2330.1, 2330.2, 2330.3, and 2330.4

Section 2330.1, “Deposit Accounts” was significantly revised and reorganized. The section describes a supervised institution’s risks associated with deposits, various types of deposit programs, and key regulations related to a bank’s deposits, as well as the supervisory expectations for assessing deposit activity at a bank. The content of the section was revised to provide

- a general discussion on insured versus uninsured deposits;
- an explanation of core deposits versus non-core deposits;
- an updated description of brokered and high-rate deposits, including brokered deposit limitations and interest rate restrictions for certain depository institutions;
- a background description of reciprocal deposit programs; and
- a new discussion on the supervisory assessment of deposit activity vis-à-vis a bank’s liquidity position.

The examination procedures (section 2330.3) were removed from the manual and a note was added to the section indicating that the Examination Documentation Modules (ED Modules) contain the most relevant examination procedures on assessing deposit accounts. The examination objectives (section 2330.2) and internal control questionnaire (section 2330.4) were removed from the manual.

Section 3210.1

This section, “The Discount Window and Liquidity Risk Management,” was previously titled, “Short-Term Liquidity Management (Federal Reserve’s Primary Credit Program).” This section now includes an overview of the discount window. The section outlines the three Federal Reserve credit programs that are available to depository institutions under Regulation A: (1) primary credit, (2) secondary credit, and (3) seasonal credit programs. Revisions were made to the discussion on appropriate liquidity risk management practices for a supervised institution as well as contingency funding planning practices for institutions that use the discount window. For more information, see the *Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans.*

Sections 3220.1, 3220.2, 3220.3, and 3220.4

Section 3220.1, "Borrowed Funds," was primarily revised to remove content about the Federal Reserve's discount window that has been moved to Section 3210.1, "The Discount Window and Liquidity Risk Management." Outdated information about reserve requirements, as discussed in Regulation D, was also removed from the section.

The examination procedures (section 3220.3) were removed from the manual and a note was added to the section indicating that the ED Modules contain the most relevant examination procedures on assessing borrowed funds. The examination objectives (section 3220.2) and internal control questionnaire (section 3220.4) were removed from the manual.

Section 4011.1

This section, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion," was revised to cover the supervision of institutions having less than $100 billion in total consolidated assets. Previously, the guidance in the section applied to the supervision of institutions with less than $50 billion in total consolidated assets. In addition, a reference was included highlighting the risk committee requirements for bank holding companies (BHCs) with total consolidated assets of $50 billion or more and less than $100 billion in the Board's Regulation YY (12 CFR pt. 252, subpart C).

Section 4012.1

The section, "Risk-Management Processes and Internal Controls of Firms Having $100 Billion or More in Total Assets," was revised to cover the supervision of SMBs and BHCs having $100 billion or more in total consolidated assets, rather than SMBs and BHCs having $50 billion or more in total consolidated assets. Further, this section was updated to reflect the Federal Reserve's guidance for a supervised institution's boards of directors in SR-21-3/CA-21-1, "Supervisory Guidance on Board of Directors' Effectiveness." Specifically, the section was revised to better reflect the roles and responsibilities of a supervised institution's the board of directors and senior management.

Section 4030.1

Section 4030.1, "Asset Securitization," was significantly revised. Lengthy descriptions of outdated risk-based capital provisions affecting a supervised institution's asset securitizations were removed. Several examples about the capital treatment of asset securitizations were removed as they no longer reflect the Board's current capital regulations. Outdated accounting references and descriptions were removed from the section. Discussions on asset-backed commercial paper programs were also removed as this topic is covered in section 3030.1, "Overview of Asset-Backed Commercial Paper Programs." The section provides a primer on asset securitization activities and provides an overview on a supervised institution's risk management considerations for conducting asset securitization activities. The section was revised to consolidate supervisory considerations for assessing a supervised institution's asset securitizations into a single subsection.

Section 4062.1

This section, "Risk Management of Third-Party Relationships," was previously called "Managing Outsourcing Risk." This section provides a summary of *Interagency Guidance on Third-Party Relationships* issued by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency on sound risk-management principles that a supervised institution should consider in managing the risks associated with third-party relationships. For the complete guidance see SR-23-4, “Interagency Guidance on Third-Party Relationships: Risk Management.”

Sections 5300.1, 5300.2, 5300.3, and 5300.4

Section 5300.1, “Information Technology,” was revised primarily to remove content that is explained in other sections of the manual. Guidance in section 5300.1 that addressed Regulation V (12 CFR pt. 222), *Fair Credit Reporting*, and the identity theft red flags rule was removed. This guidance was updated and moved to section 6068.1 of the manual. Guidance on the outsourcing of information technology services was removed from section 5300.1 as more relevant guidance can be found in section 4062.1, “Risk Management of Third-Party Relationships.” This section also was updated to reflect the Federal Reserve’s guidance for a supervised institution’s boards of directors in SR-21-3/CA-21-1, “Supervisory Guidance on Board of Directors’ Effectiveness.” Specifically, the section was revised to better reflect the roles and responsibilities of a supervised institution’s board of directors and senior management. Hyperlinks were added to guidance issuances that are still active. Inactive guidance references in the section were removed or updated, as deemed appropriate. The examination procedures (section 5300.3) were removed from the manual and a note was added to the section indicating that the Federal Financial Institutions Examination Council manuals contain the most relevant examination procedures on conducting information technology examinations. The examination objectives (section 5300.2) and internal control questionnaire (section 5300.4) were removed from the manual.

Section 5320.1

Section 5320.1, “Payment System Risk and Electronic Funds Transfer Activities,” was significantly revised. Most of the content related to payment system risk and the Board’s Policy on Payment System Risk (PSR policy) was removed from the section as the material was outdated. The latest and most comprehensive information about the PSR policy can be found on the Board’s public website. Therefore, this section provides an overview of the PSR policy and references with hyperlinks to the Board’s public website where the latest PSR policy and other related policy documents can be found. Except for removing a brief subsection on Telex systems, the other content in the section related to electronic funds transfer activities was not revised.

Section 5330.1

This new section, “Crypto-Asset-Related Activities and Exposures,” provides an overview on the crypto-asset-related activities of SMBs. Crypto-asset-related activities may include, but are not limited to, crypto-asset safekeeping and traditional custody services; ancillary custody services; loans collateralized by crypto-assets; and issuance and distribution of dollar tokens. The section clarifies supervisory expectations regarding the requirements for SMBs to notify the Federal Reserve about the intent to engage in crypto-asset-related activities and describes the supervisory nonobjection process for SMBs seeking to engage in certain activities involving dollar tokens. The section also highlights key Federal Reserve guidance on crypto-asset-related risks to banking organizations and supervisory considerations in assessing SMBs engaged in crypto-asset-related activities and discusses the legal permissibility of crypto-asset-related activities.

Section 6068.1

This new section, “Regulation V: Fair Credit Reporting (Identity Theft Red Flags),” contains information about Board’s Regulation V—Fair Credit Reporting (12 CFR pt. 222), specifically, the identity theft red flag rule. The goal of the identity theft red flags rule and its guidelines (12 CFR pt. 222, Appendix J) is to ensure that financial institutions and creditors are alert for signs or indicators that an identity thief is misusing another individual’s sensitive data, typically to obtain products or services from an institution or creditor. Previously, guidance on this subject was in section 5300.1, “Information Technology.” Most of the information on Regulation V and the identity theft red flags rule has been removed from section 5300.1.

Section 6080.1

Minor technical edits were made to section 6068.1, "Regulation Y: Prohibitions Against Tying Arrangements." The section's content covers section 106 of the Bank Holding Company Act Amendments of 1970 (section 106), which prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank. In addition to the statutory exceptions set forth in section 106, additional regulatory exceptions can be found in the Board's Regulation Y (12 CFR 225.7). This section was edited to more closely with information presented in the *Bank Holding Company Supervision Manual*, Section 3500.0, "Prohibitions Against Tying Arrangements."

Commercial Bank Examination Manual
Supplement 54—May 2022

SUMMARY OF CHANGES

This supplement reflects Board of Governors actions, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation have issued since the publication of the May 2021 supplement.

ELIMINATION OF CERTAIN SECTIONS COVERING EXAMINATION OBJECTIVES, EXAMINATION PROCEDURES, AND INTERNAL CONTROL QUESTIONNAIRES

The Examination Documentation modules (ED modules) define common objectives for the review of key bank activities at state chartered banks, which are supervised by the Federal Reserve, Federal Deposit Insurance Corporation, and state banking agencies. At the Federal Reserve, supervisory staff use examination procedures in the ED modules to document examination work at state member banks in the community and regional supervisory portfolios. The ED modules are available on the Board's website. To reduce the publication of duplicative and outdated material, the sections listed in the table below have been eliminated from the *Commercial Bank Examination Manual*. The relevant examination procedures sections (i.e., section number ending with ".3") will contain a link to the ED modules page on the Board's website and a listing of ED module titles related to the section.

FOREWORD

This manual's Foreword was updated to explain that relevant examination procedures sections will contain a link to the ED modules page on the Board's website.

Sections Removed	*Relevant ED Modules*
• 2010.2, "Loan Portfolio Management, Examination Objectives" • 2010.3, "Loan Portfolio Management, Examination Procedures"	• Loan Portfolio Review • Loan Operations Review
• 2138.3, "Mortgage Banking, Examination Procedures"	• Mortgage Banking
• 2300.2, "Other Assets and Other Liabilities, Examination Objectives" • 2300.3, "Other Assets and Other Liabilities, Examination Procedures" • 2300.4, "Other Assets and Other Liabilities, Internal Control Questionnaire"	• Other Assets and Liabilities
• 2500.2, "Investment Securities and End-User Activities, Examination Objectives" • 2500.3, "Investment Securities and End-User Activities, Examination Procedures" • 2500.4, "Investment Securities and End-User Activities, Internal Control Questionnaire"	• Securities and Derivatives
• 3000.2, "Assessment of Capital Adequacy, Examination Procedures" • 3000.3, "Assessment of Capital Adequacy, Examination Procedures"	• Capital

Sections Removed	*Relevant ED Modules*
• 3100.2, “Earnings—Analytical Review of Income and Expense, Examination Objectives” • 3100.3, “Earnings—Analytical Review of Income and Expense, Examination Procedures” • 3100.4, “Earnings—Analytical Review and Income and Expense, Internal Control Questionnaire”	• Earnings
• 3200.2, “Liquidity Risk, Examination Objectives” • 3200.3, “Liquidity Risk, Examination Procedures” • 3200.4, “Liquidity Risk, Internal Control Questionnaire”	• Liquidity
• 3300.2, “Interest Rate Risk Management, Examination Objectives” • 3300.3, “Interest Rate Risk Management, Examination Procedures”	• Rate Sensitivity
• 4030.2, “Asset Securitization, Examination Objectives” • 4030.3, “Asset Securitization, Examination Procedures” • 4030.4, “Asset Securitization, Internal Control Questionnaire”	• Securitization
• 4500.2, “Internal Control and Audit Function, Oversight, and Outsourcing, Examination Objectives” • 4500.3, “Internal Control and Audit Function, Oversight, and Outsourcing, Examination Procedures” • 4500.4, “Internal Control and Audit Function, Oversight, and Outsourcing, Internal Control Questionnaire”	• Management and Internal Control Evaluation • Internal and External Audit Evaluation
• 5200.3, “Fiduciary Activities, Examination Procedures” *(New section)*	• Trust
• 5320.2, “Payment System Risk and Electronic Funds Transfer Activities, Examination Objectives” • 5320.3, “Payment System Risk and Electronic Funds Transfer Activities, Examination Procedures” • 5320.4, “Payment System Risk and Electronic Funds Transfer Activities, Internal Control Questionnaire”	• Electronic Funds Transfer Risk Assessment
• 6072.2, “Regulation W: Bank-Related Organizations, Examination Objectives” • 6072.3, “Regulation W: Bank-Related Organizations, Examination Procedures”	• Related Organizations

SUMMARY OF CHANGES

This supplement reflects Board of Governors actions, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation have issued since the publication of the November 2020 supplement.

REORGANIZATION OF THE *COMMERCIAL BANK EXAMINATION MANUAL*

The manual has been reorganized to align its content to follow the components of the Uniform Financial Institutions Rating System or CAMELS rating system. The CAMELS components are Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Prior to this May 2021 reorganization, the manual was structured around a bank's balance sheet (such as assets, liabilities, retained earnings, and capital). This reorganization is intended to better align the manual sections with the examination process. The Table of Contents displays the new organization in greater detail.

Other than the changes to the sections described below, there were no substantive changes to the manual content. In most instances, the revision date in the footer of a manual page did not change as a result of the reorganization. As the content in sections is revised, cross references to manual sections will be revised to reflect the reorganization. Other technical edits that were made in this update as a result of the content reorganization include

- *Removal of section point pages.* Point pages were used when the manual was available in hard copy form. The point pages provided an easy way to add pages to the manual binder without having to re-print the entire section. These point pages are no longer necessary as the Board ended the option of ordering print versions for the *Commercial Bank Examination Manual* in 2017. Therefore, the point pages were removed from sections and the pagination of a section was sequenced.
- *Resequencing footnotes in sections.* Footnotes that were inserted into sections and numbered 1a, 1b, 1c, etc. were revised to be in sequential order: 1, 2, 3, and so forth.
- *Removal of "What's New in this Revised Section" verbiage.* Several sections contained a summary of modifications on the first page of the section. In most instances, these descriptions were several years old. Further, the Summary of Changes for each manual update describes the changes to the manual sections. Therefore, the "What's New in this Revised Section" text has been removed.
- *Active hyperlinks.* If a section contains a web address as a reference, the web address has been enabled to allow users to access content by clicking on the link.

Foreword

The Foreword was revised to remove outdated information on the banking environment and historical information on the development of the risk-focused examination process. The Foreword now describes the differences between supervision and regulation. It highlights the Federal Reserve's supervisory and regulatory authority over certain insured depository institutions, namely, state member banks. The Foreword notes that the Federal Reserve is required by statute to complete a full-scope examination for each state member bank. Section 10(d) of the Federal Deposit Insurance Act generally requires the appropriate federal banking agency for an insured depository institution to conduct a full scope examination at least once every 12 months, but permits a longer cycle—at least once every 18 months—for insured depository institutions that meet certain criteria. Lastly, the Foreword's "How to Use This Manual" subsection was revised to describe the new organization of the manual.

Complex Wholesale Borrowings

The sections covering "Complex Wholesale Borrowings" (formerly sections 3012.1, 3012.2, 3012.3, and 3012.4) were removed from the manual. The information in these sections was based entirely on SR-01-8, "Supervisory Guidance on Complex Wholesale Borrowings." SR-01-8 was made inactive by SR-21-4/ CA 21-2, “Inactive or Revised SR Letters Related to the Federal Reserve’s Supervisory Expectations for a Firm’s Boards of Directors.” For more information on complex wholesale borrowings, refer to the *Trading and Capital Markets Activities Manual* sections on Liquidity Risk and Interest-Rate Risk Management; SR-10-6, “Interagency Policy Statement on Funding and Liquidity Risk Management”; and Regulation YY (12 CFR 252).

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Former section 7110.4 was removed from the manual. This section provided a sample first day letter request list for examiners conducting an examination of a bank’s lesser developed country asset sales, purchases, swaps, options, and rental programs. The guidance was outdated. Further, as noted in the Foreword, “.4” sections (e.g., section 7110.4) in the manual should contain internal control questionnaires. As section 7110.4 did not contain an internal control questionnaire per the manual’s design format, the section was deleted until such time as the need for an internal control questionnaire is identified for this type of bank activity.

Commercial Bank Examination Manual
Supplement 52—November 2020

Summary of Changes

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the April 2020 supplement.

Section 1000.1

Section 1000.1, "Examination Strategy and Risk-Focused Examinations," was revised to update the subsection on de novo bank examination frequency and scope. A de novo bank is a bank that has been in operation for three years or less. The section provides information on supervisory expectations for de novo subsidiaries of bank holding companies with assets greater than $3 billion. In addition, the section explains that de novo state member banks are ineligible for the alternate examination program for the first three years of their operations. *See* SR-20-16, "Supervision of De Novo State Member Banks."

Section 1001.1

Section 1001.1, "Community Bank Supervision Process," was updated to explain the updated template for the report of examination for state member banks with less than $10 billion in total assets. Significant updates to this template are as follows.

- The former *Matters Requiring Board Attention* page was renamed to the *Matters Requiring Attention* page. The updated page also includes a reference to SR-18-5/CA-18-7, "Interagency Statement Clarifying the Role of Supervisory Guidance."
- The *Directorate Responsibility* page was updated to include standard language informing the bank of its right to appeal material supervisory determinations. *See* 85 *Federal Register* 15,175 (March 17, 2020) for more information on the Federal Reserve's appeals process.
- The former *Summary of Examination Ratings and Conclusions* page was broken into two distinct sections entitled *Summary of Examination Ratings* and *Examiner Conclusions.* The *Summary of Examination Ratings* section contains the numerical ratings of the bank. The *Examiner Conclusions* section contains a qualitative summary of examiners' supervisory activity.
- The *Concentrations of Credit* page instructions were updated to note that the "Concentrations of Credit" section to the manual and SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," provide more information on the calculation of the denominator of concentration ratios.

Sections 2024.1, 2024.2, and 2024.3

Section 2024.1, "Private Placements," is a new section. This section is based on material from section 4130, which was reorganized to differentiate content explaining risk-management practices at a supervised institution from examination practices and considerations in reviewing private placement activities. Section 2024.1 provides more background information concerning the Securities and Exchange Commission's rules related to private placements. Sections 2024.2, "Examination Objectives," and 2024.3, "Examination Procedures," were also revised.

Sections 2040.1, 2040.2, 2040.3, and 2040.4

Section 2040.1, "Loan Portfolio Management," was updated to remove material on tying arrangements as this topic is addressed in section 6080.1, "Regulation Y: Prohibitions Against Tying Arrangements." The discussion of credit risk review systems was also removed. See the explanation of changes to section 2041.1 for more information. The material related to mortgage banking was removed and converted into a new standalone manual section (2044.1). Sections 2040.2, "Examination Objectives," and 2040.3, "Examination Procedures," were also revised to align with the interagency examination documentation (ED) modules. Section 2040.4, "Loan Portfolio Management: Internal Control Questionnaire," was removed from the manual.

Section 2041.1

This new section, "Credit Risk Review Systems," describes the "Interagency Guidance on Credit Risk Review Systems" issued by the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and National Credit Union Administration (NCUA). The guidance discusses sound management of credit risk, a system of independent, ongoing credit review, and appropriate communication regarding the performance of an institution's loan portfolio to its management and board of directors. This interagency guidance replaces attachment 1 of the 2006 "Interagency Policy Statement on the Allowance for Loan and Lease Losses." *See* 85 *Federal Register* 33,278 (June 1, 2020) and SR-20-13.

Sections 2044.1 and 2044.3

These new sections address "Mortgage Banking" and contain relevant information that was previously in section 2040.1, "Loan Portfolio Management." While the information pertaining to the risk management of mortgage banking remains relevant, the accounting references are outdated and will be revised in a future update to the manual. In addition, the examination procedures that were previously located in section A.2040.3, "Loan Portfolio Management: Comprehensive Mortgage Banking Examination Procedures," were moved to section 2044.3, "Mortgage Banking: Examination Procedures."

Sections 2050.1, 2050.2, 2050.3, and 2050.4

Section 2050.1, "Concentrations of Credit," incorporates guidance issued by the Federal Reserve, FDIC, and OCC (agencies) on a common approach for defining credit concentration ratios. As of March 31, 2020, for banks that have adopted the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 326, Financial Instruments—Credit Losses that implements the current expected credit losses (CECL) methodology, the agencies' examiners will calculate credit concentration ratios using tier 1 capital plus the allowance for credit losses attributed to loans and leases as the denominator. For institutions that have not adopted CECL, the agencies' examiners calculate credit concentration ratios using tier 1 capital plus the entire allowance for loan and lease losses as the denominator. Further, section 2050.1 was reorganized and a new subsection on supervisory considerations for assessing concentrations was added. Section 2050.2, "Concentrations of Credit: Examination Objectives," section 2050.3, "Concentrations of Credit: Examination Procedures," and section 2050.4, "Concentrations of Credit: Internal Control Questionnaire," were removed from the manual.

Sections 2070.1, 2070.2, 2070.3, and 2070.4

Section 2070.1, "Allowance for Loan and Lease Losses," which contains the 2006 "Interagency Policy Statement on the Allowance for Loan and Lease Losses," (SR-06-17) was revised to remove the attachment to the policy statement on loan review systems. This guidance on loan review systems was superseded by SR-20-13 and is available in section 2041.1, "Credit Risk Review Systems." Section 2070.3, "Examination Procedures," has been revised to align with the interagency ED modules. Sections 2070.2, "Examination Objectives," and section 2070.4, "Internal Control Questionnaire, were removed from the manual. See the explanatory note on SR-06-17 for more information.

Sections 2071.1 and 2071.3

Section 2071.1, "Allowance for Credit Losses," is a new section that incorporates the "Interagency Policy Statement on Allowances for Credit Losses." (*See* SR-20-12.) The Federal Reserve, OCC, FDIC, and NCUA issued this statement to address the changes to U.S. generally accepted accounting principles as promulgated by the FASB in Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments and subsequent amendments issued since June 2016. The May 2020 statement describes the measurement of expected credit losses under the CECL methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate allowances for credit losses (ACLs); the responsibilities of boards of directors and management; and examiners' review of a bank's ACLs. With the issuance of the May 2020 statement, the 2006 "Interagency Policy Statement on the Allowance for Loan and Lease Losses" is partially superseded for institutions that have adopted the CECL methodology. The 2006 statement will be made inactive after all institutions have adopted the CECL methodology in 2023. Section 2071.3, "Allowance for Credit Losses: Examination Procedures," was added to the manual.

Sections 2072.2 and 2072.3

Section 2072.2, "ALLL Methodologies and Documentation: Examination Objectives" and 2072.3, "ALLL Methodologies and Documentation: Examination Procedures" were removed from the manual. The examination objectives and procedures for assessing an institution's ALLL methodology are fully incorporated into sections 2070.2 and 2070.3. In addition, procedures for assessing an institution's allowance for credit losses methodology are found in section 2071.3.

Sections 2080.1 and 2080.4

Section 2080.1, "Commercial and Industrial Loans," was revised to remove the discussion on the shared national credits program, which is now a standalone section to the manual. *See* section 2089.1. Much of the content in the subsection on "Tie-In Arrangements," was removed because this topic is covered in this manual's section 6080.1, "Regulation Y: Prohibitions Against Tying Arrangements." Section 2080.4, "Commercial and Industrial Loans: Internal Control Questionnaire," was removed from the manual.

Section 2088.1

This section, "Off-site Review of Loan Files," was revised to modify the applicability of the guidance in the section. The guidance applies to the assessment of state member banks with less than $100 billion in total assets that are in the community banking organization (CBO) and regional banking organization (RBO) supervisory portfolios. Previously, the guidance applied to the assessment of state member banks with less than $50 billion in the CBO and RBO supervisory portfolios. The section also notes that Reserve Banks and the state member bank should discuss the technical procedures and security practices for conducting off-site loan reviews when contingency operating circumstances necessitate a full-time telework environment.

Section 2089.1

This new section, "Shared National Credits," provides a high-level description of the Shared National Credits (SNC) supervisory program. The Federal Reserve, OCC, and FDIC established the SNC program to evaluate large and complex syndicated credits. The program provides for uniform treatment and increased efficiency in shared-credit risk analysis and classification of the largest and most complex credits shared by multiple financial institutions.

Section 3020.1

This section, "Assessment of Capital Adequacy," was revised to include

- A revised definition to high volatility commercial real estate (HVCRE). Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) modified the capital treatment of HVCRE by adding section 51 to the Federal Deposit Insurance Act (FDIA).
- A discussion on the community bank leverage ratio (CBLR) framework. The CBLR framework provides for a simple measure of capital adequacy for certain community banking organizations, consistent with section 201 of the EGRRCPA.
- Updated information regarding supervisory leverage ratio expectations for de novo banks. In general, the Federal Reserve expects each de novo bank to maintain a tier 1 leverage ratio of at least 8 percent for the first three years of its existence. *See* SR-20-16.
- Updates to the stress capital buffer and the countercyclical capital buffer requirements.

- References to adjusted allowances for credit losses, which applies to institutions that have adopted the CECL methodology.

Sections 3035.1 and 3035.3

The material in these new sections on "Prompt Corrective Action" was previously in section 4133. These sections were created so that the material would be closer to other sections in the manual related to capital. Section 3035.1 was revised to describe the prompt corrective action (PCA) implications for institutions that qualify for and opt in to the CBLR framework. A depository institution or depository institution holding company that qualifies for and opts in to the CBLR framework 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). The section was also revised to describe how the supplementary leverage ratio factors into the PCA ratios for an advanced approaches bank or bank that is a Category III Board-regulated institution (as defined in 12 CFR 217.2). Section 3035.3, "Examination Procedures," was revised to include several minor technical edits.

Section 4060.1

This section, "Information Technology," was revised to remove the section's Appendix A—Risk Management of Outsources Technology Services that was rescinded by the Federal Financial Institutions Examination Council (FFIEC). *See* the FFIEC's July 15, 2004, press release. With the release of the Outsourcing Technology Services Booklet, the FFIEC decided to rescind the November 2000 guidance on "Risk Management of Outsourced Technology Services." Refer to the FFIEC Outsourcing Technology Services Booklet on the FFIEC website for current information on this topic.

Sections 4090.1, 4090.2, 4090.3, and 4090.4

Significant organizational revisions were made to section 4090.1, "Interest Rate Risk Management." This section continues to align with existing guidance on interest rate risk management. *See* SR-96-13, "Joint Policy Statement on Interest Rate Risk," and SR-10-1, "Interagency Advisory on Interest Rate Risk." Section 4090.1 was reorganized to differentiate content explaining effective interest rate risk management practices at a supervised institution from examination practices and considerations in assessing the effectiveness of an institution's interest rate risk management. Sections 4090.2, "Examination Objectives," and 4090.3, "Examination Procedures," were also revised to align with the interagency ED modules. Section 4090.4, "Interest Rate Risk Management: Internal Control Questionnaire," was removed from the manual.

Sections 4130.1, 4130.2, 4130.3, and 4130.4

The material in section 4130.1, "Private Placements," section 4130.2, "Examination Objectives," and section 4130.3, "Examination Procedures," was updated and moved to sections 2024.1, 2024.2, and 2024.3, respectively. Section 4130.4, "Private Placements: Internal Control Questionnaire," was removed from the manual.

Sections 4133.1, 4133.2, and 4133.3

Section 4133.1, "Prompt Corrective Action," and section 4133.3, "Prompt Corrective Action: Examination Procedures" were updated and moved to sections 3035.1 and 3035.3, respectively. Section 4133.2, "Prompt Corrective Action: Examination Objectives," was moved to section 3035.2 without revision.

Sections 4180.1, 4180.2, 4180.3, and 4180.4

The content of sections 4180.1, 4180.2, 4180.3, and 4180.4, collectively describing "Investment-Funds Support," was moved to section 6074 and renamed "Regulation W: Investment-Funds Support."

Sections 6074.1, 6074.2, 6074.3, and 6074.4

Section 6074.1 on “Regulation W: Investment-Funds Support,” section 6074.2, “Examination Objectives,” section 6074.3, “Examination Procedures,” and section 6074.4, “Internal Control Questionnaire,” are based on material previously in section 4180. No substantive edits were made to these sections.

Section 6080.1

This new section, “Regulation Y: Prohibitions Against Tying Arrangements” provides an overview of Section 106 of the Bank Holding Company Act Amendments of 1970 (section 106). Section 106, as implemented by the Federal Reserve Board’s Regulation Y (12 CFR 225), prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank. The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services. The outdated content related to section 106 was removed from other manual sections, namely section 2040.1, “Loan Portfolio Management,” and section 2080.1, “Commercial and Industrial Loans.”

Section A.2040.3

This section, “Loan Portfolio Management: Comprehensive Mortgage Banking: Examination Procedures” was incorporated into section 2044.3, “Mortgage Banking: Examination Procedures.” As a result, section A.2040.3 was removed from the manual.

Commercial Bank Examination Manual
Supplement 51—April 2020

Summary of Changes

This supplement reflects decisions of the Board of Governors, new and revised statutory and regulatory provisions, supervisory guidance, and instructions that the Division of Supervision and Regulation has issued since the publication of the May 2019 supplement.

Table of Contents

The Table of Contents was updated to reflect the changes described below. In addition, the 6000 series major section heading was updated to remove the commercial bank report of examination template and instructions, which are in section 1001.1 of the manual. Going forward, the 6000 series major section heading will contain sections on key regulations that pertain to safety and soundness examinations of state member banks. These sections summarize and explain the rules, as amended, but are not substitutes for the rules themselves.

Section 1000.1

This section, "Examination Strategy and Risk-Focused Examinations," was updated to note that examiners should convey, if evident, both the root cause of a supervisory finding and the potential effect of a finding on the organization. The section also describes key factors examiners should consider in determining whether to recommend additional formal or informal investigation or enforcement action for an organization. Lastly, the section also includes a reference to SR-18-5/CA-18-7, "Interagency Statement Clarifying the Role of Supervisory Guidance," which examiners should also consider when communicating supervisory findings.

Section 1001.1

Minor updates were made to section 1001.1, "Community Bank Supervision Process." This section includes references to SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," and SR-19-9, "Bank Exams Tailored to Risk (BETR)." Minor typographical errors were corrected.

Sections 1020.1, 1020.2, and 1020.3

Section 1020.1, "Federal Reserve System Bank Surveillance Program," was updated to include information on the Federal Reserve's use of outlier metrics to assist examiners and other supervisory staff in determining the scope of safety-and-soundness examinations. The role of outlier metrics is particularly important in pre-examination planning at community and regional state member banks. Combined with examiner judgment, outlier metrics are used to classify the levels of risk at a state member bank within individual risk dimensions, such as credit, liquidity, and operational risk. Federal Reserve examiners then tailor the bank examination to reflect the levels of risk present. See SR-19-9, "Bank Exams Tailored to Risk (BETR)," for more information. The examination objectives (section 1020.2) and examination procedures (section 1020.3) also were revised.

Section 2040.1

This section, "Loan Portfolio Management," was updated to remove the discussion related to Regulation O, which is now covered in section 6050.1 of the manual.

Sections 2110.1, 2110.2, 2110.3, and 2110.4

This section, "Floor Plan Loans," was revised to improve its clarity and to add additional guidance references. For instance, material in the section was revised to consolidate supervisory considerations in the review of a bank's floor plan loans into one part of the section. The examination procedures in section 2120.3 were also revised to align with the interagency examination documentation (ED) modules. Section 2120.2, "Floor Plan Loans: Examination Objectives" and section 2120.4, "Floor Plan Loans: Internal Control Questionnaire," were removed from the manual.

Sections 2120.1, 2120.2, 2120.3, and 2120.4

Section 2120.1, "Direct Financing Leases," was revised to provide updated accounting references for lease accounting. The section states that leases should be accounted for in accordance with accounting standards issued by the Financial Accounting Standards Board (FASB). The lease accounting standard currently applied by public business entities, "Leases (Topic 842)," was issued by FASB in February 2016, and supersede ASC Topic 840, Leases, by 2021. The examination procedures in section 2120.3 were revised to align with the interagency ED modules. Section 2120.2, "Direct Financing Leases: Examination Objectives" and section 2120.4, "Direct Financing Leases: Internal Control Questionnaire," were removed from the manual.

Sections 3025.1 and 3025.3

This new section, "Dividends," was previously section 4070.1. In addition to moving the section closer to the other sections in the manual related to capital, this section was revised to include references to guidance on capital planning processes, including the issuance of dividends, for bank subsidiaries of large holding companies. The section also includes a new discussion on the capital conservation buffer, which 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. (See 12 CFR 217.) The examination procedures in section 3025.3 were also revised.

Sections 4050.1, 4050.2, 4050.3, and 4050.4

The contents of "Transactions Between Member Banks and Their Affiliates" (sections 4050.1, 4050.2, and 4050.3), were moved to section 6070 and renamed "Regulation W: Transactions Between Member Banks and Their Affiliates." Section 4050.4 was removed from the manual.

Sections 4052.1, 4052.2, 4052.3, and 4052.4

The contents of "Bank-Related Organizations" (sections 4052.1, 4052.2, and 4052.3), were moved to section 6072 and renamed "Regulation W: Bank-Related Organizations." Section 4052.4 was removed from the manual.

Sections 4070.1, 4070.2, 4070.3, and 4070.4

The contents of sections 4070.1, "Dividends," and 4070.3, "Dividends: Examination Procedures," were updated and moved to sections 3025.1 and 3025.3 of the manual, respectively. Section 4070.2, "Dividends: Examination Objectives," and section 4070.4, "Dividends: Internal Control Questionnaire," were removed from the manual.

Section 5000.1

This section, "Duties and Responsibilities of Directors," was updated to remove contents related to the Depository Institution Management Interlocks Act as implemented by Regulation L. The relevant content on Regulation L was moved to section 6040.1, "Regulation L: Depository Institution Management Interlocks Act."

Section 5020.1

This section, "Overall Conclusions Regarding Condition of the Bank," was updated to remove the contents related to the review of Bank Secrecy Act (BSA) and anti-money-laundering (AML) compliance at state member banks. Section 6010.1, "Regulation H: Bank Secrecy Act and Anti-Money-Laundering," was developed to provide a brief description of supervisory activities related to the review of BSA and AML compliance programs at state member banks.

Section 6000.1

Section 6000.1, "Commercial Bank Report of Examination," was removed from the manual. The primary report of examination template is located in section 1001.1, "Community Bank

Supervision Process." The 6000 series major section heading will contain sections on key regulations that pertain to safety-and-soundness examinations of state member banks.

Section 6010.1

This new section, "Regulation H: Bank Secrecy Act and Anti-Money-Laundering," was developed to provide a brief introduction of the BSA and AML compliance program and suspicious activity reporting requirements for banks under Regulation H. The section notes that additional details on the BSA/AML program, suspicious activity reporting requirements, and all other laws, regulations, and examination procedures pertaining to the BSA, are described in the *Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual.*

Section 6040.1

This new section, "Regulation L: Depository Institution Management Interlocks Act," provides an overview of the Depository Institution Management Interlocks Act, as implemented by Regulation L (12 CFR 212) and subpart J of Regulation LL (12 CFR 238.91-.99). These regulations prohibit a management official of a depository institution or depository institution holding company from serving simultaneously as a management official of another depository organization if the organizations are not affiliated and both either are very large or are located in the same local area.

Sections 6050.1 and 6050.3

This new section, "Regulation O: Loans to Executive Officers, Directors, And Principal Shareholders of Member Banks," provides an overview of the Federal Reserve Board's Regulation O (12 CFR 215), which implements many of the laws pertaining to extensions of credit by banks to their insiders. Regulation O is designed to mitigate the potential for conflicts of interest and self-dealing by individuals who may be in a position to influence a bank's lending decisions. The section outlines Board staff legal opinions on Regulation O and supervisory considerations for assessing compliance with Regulation O. The content in section 2040.1 related to Regulation O was removed from the manual. Examination procedures (refer to section 6050.3) were developed.

Sections 6070.1, 6070.2, and 6070.3

This new section, "Regulation W: Transactions Between Member Banks and Their Affiliates," contains the content that was previously in section 4050. No substantive edits were made to this content. As a result, section 4050 was removed from the manual.

Sections 6072.1, 6072.2, and 6072.3

This new section, "Regulation W: Bank-Related Organizations," contains the content that was previously in section 4052. No substantive edits were made to this content. As a result, section 4052 was removed from the manual.

Commercial Bank Examination Manual
Supplement 50—May 2019

Summary of Changes

Section 1000.1

Section 1000.1, "Examination Strategy and Risk-Focused Examinations," was significantly revised and reorganized. This section addresses key aspects of the Federal Reserve's supervisory process for safety and soundness examinations for state member banks. Some of the most significant topics covered in this section include examination authority, compliance with laws and the role of guidance, applications under Regulation H (12 CFR part 208), state member bank examination frequency, coordinating supervisory activities, and communicating supervisory findings. Subsequent sections in the manual further describe the examination and supervisory practices that apply to particular supervisory portfolios of state member banks.

Section 1001.1

This new section, "Community Bank Supervision Process," discusses some of the most significant aspects in the preparation and execution of an examination of a state member bank with $10 billion or less in total assets. The section explains the risk-focused process for examining community banks and describes the written products that facilitate this process. In addition, the section provides an updated description of the community bank report of examination and a revised illustrative template of the community bank report of examination. Relevant report of examination content that was previously in sections 6003.1 and 6005.1 has been incorporated into section 1001.1.

Section 1007.1

This section, "Other Types of Examinations," was previously Section 6010.1. In addition to the reorganization of the material in this new section, section 1007.1 addresses the Board's final rules that expanded the examination cycle for certain small state member banks and U.S. branches and agencies of foreign banks. The final rules (83 *Fed. Reg.* 67,033 (December 28, 2018)) adopted the interim final rules (83 *Fed. Reg.* 43,961 (August 29, 2018)) without change. The final rules amended Regulation H (12 CFR part 208) and Regulation K (12 CFR part 211), which raised the total asset threshold (from less than $1 billion to less than $3 billion in assets) for certain qualifying state member banks and U.S. branches and agencies of foreign banks to be eligible for an 18-month examination cycle. See SR-18-7, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations," for more information.

Section 1011.1

The contents of this new section, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion," were previously part of section 1000.1, "Examination Strategy and Risk-Focused Examinations." A new section was developed to improve the organization and presentation of manual content. The new section also provides more information on the applicability of the guidance to supervised institutions as well as updates for several references.

Section 1012.1

The contents of this new section, "Risk Management Processes and Internal Controls of Firms Having $50 Billion or More in Total Assets," were previously part of section 1000.1, "Examination Strategy and Risk-Focused Examinations." A new section was developed to improve the organization and presentation of manual content. In addition to the content being moved, the section provides more information on the applicability of the guidance to supervised institutions and contains minor editorial edits.

Section 2190.1

Section 2190.1, "Bank Premises and Equipment," was revised to provide updated accounting standards about leases. In February 2016, the Financial Accounting Standards Board (FASB) issued a new accounting standard on leases, Accounting Standards Update No. 2016-02, Leases (Topic 842), which revises the accounting for lease transactions. The section also was revised to provide guidance on the treatment of operating leases as an investment in bank premises under Regulation H upon the implementation of the new lease accounting standard. See SR-19-7, "Statement on the Implications of the New Lease Accounting Standard on Regulation H," for more information. The examination objectives (section 2190.2), examination procedures (section 2190.3), and internal control questionnaire (section 2190.4) also were revised.

Section 3050.1

Section 3050.1, "Dodd-Frank Act Company-Run Stress Testing for Banking Organizations with Total Consolidated Assets $10–50 Billion," has been removed from the *Commercial Bank Examination Manual*. Eighteen months after the Economic Growth, Regulatory Relief, and Consumer Protection Act's (EGRRCPA) enactment (May 24, 2018), financial companies with total consolidated assets of less than $250 billion that are not bank holding companies (BHCs) will no longer be subject to the company-run stress testing requirements in section 165(i)(2) of the Dodd-Frank Act. On EGRRCPA's date of enactment, BHCs under $100 billion in total consolidated assets were no longer subject to section 165(i)(2). The agencies' regulations implementing company-run stress testing provide that the agencies may extend any deadline relating to company-run stress testing. In order to avoid unnecessary burden for depository institutions (including state member banks) and to maintain consistency between BHCs and depository institutions, the agencies are extending the deadlines for all regulatory requirements related to company-run stress testing for depository institutions with average total consolidated assets of less than $100 billion until November 25, 2019 (at which time both statutory exemptions will be in effect). For more information, see the interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act issued on July 6, 2018.

Sections 4140.1, 4140.2, 4140.3, and 4140.4

Section 4140.1, "Real Estate Appraisals and Evaluations," has been revised significantly. This section provides a brief summary of the Board's appraisal regulations and directs readers to the key pieces of guidance that the Board and other banking agencies have issued relating to real estate appraisals and evaluations. Previously, section 4140.1 contained the entire contents of the December 2010 "Interagency Appraisal and Evaluation Guidelines." The revised manual section includes a brief summary of the December 2010 Interagency Appraisal and Evaluation Guidelines, as well as a hyperlink to the guidelines. (See SR-10-16.) The examination objectives (section 4040.2), examination procedures (section 4140.3), and internal control questionnaire (section 4140.4) also were revised.

Section 6000.1

This section, "Commercial Bank Report of Examination," has been revised to remove much of the content related to the communication of supervisory findings. This content on the communication of supervisory findings has been incorporated into the revised section 1000.1, "Examination Strategy and Risk-Focused Examinations," to improve manual content organization.

Sections 6003.1 and 6005.1

The relevant content from section 6003.1, "Community Bank Examination Report," and content of 6005.1, "Community State Member Banks and Holding Companies Rated Composite "4" or "5" (Examination and Inspection Report Format)," have been incorporated into section 1001.1, "Community Bank Supervision Process." As a result, sections 6003.1 and 6005.1 were removed from the *Commercial Bank Examination Manual*.

Section 6010.1

The relevant content in this section, "Other Types of Examinations," was moved to section 1007.1 of this manual to consolidate high-level supervisory process information into the 1000 sections of the manual. Accordingly, section 6010.1 was removed from the *Commercial Bank Examination Manual*.

Section A.2000.1

This section, “Cash Accounts: Financial Recordkeeping and Reporting Regulations-Examination Procedures,” was removed from the *Commercial Bank Examination Manual*. This section was a placeholder and did not contain background information or examination procedures. For more information and examination procedures on monetary instrument recordkeeping requirements under the Bank Secrecy Act, see the Federal Financial Institutions Examination Council *Bank Secrecy Act/Anti-Money Laundering Examination Manual*.

Section A.4140.1

Real Estate Appraisals and Evaluations: Appendixes A-D was removed from the *Commercial Bank Examination Manual*. The appendix provided a commentary on the 12 exemptions from the agencies’ appraisal regulations and explanation of the agencies’ statutory authority to provide for appraisal regulatory exemptions and the application of these exemptions. This information is provided in the 2010 Interagency Appraisal and Evaluation Guidelines. (See SR-10-16). Section 4140.1 was revised to include hyperlinks to these appendixes and include brief summaries of the appendixes. As a result of the revisions to section 4140.1, the information in section A.4140.1 was determined to be duplicative and, therefore, was removed from the manual.

Foreword

INTRODUCTION

The Federal Reserve shares supervisory and regulatory responsibility for federally insured banks with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation at the federal level, and with individual state banking departments at the state level. The Federal Reserve is the primary federal supervisor of state-chartered banks that have chosen to join the Federal Reserve System (which are referred to as "state member banks").

Regulation and supervision are distinct, but complementary, activities. Regulation entails establishing the rules within which banks must operate—in other words, regulations govern the formation, operations, activities, and acquisitions of banks. Once the Federal Reserve Board or another government entity adopts a regulation, the Federal Reserve's supervision process includes monitoring, inspecting, and examining banks to assess whether a bank is in compliance with banking laws and regulations, and whether it is operating in a safe and sound manner. Further, through the supervision process, examiners evaluate a bank's risk profile as well as the adequacy of a bank's risk management to identify, manage, and control the risks arising from the bank's business operations and activities.

New laws, regulations, supervisory policies, guidance, and interpretations result from emerging conditions and trends in the banking industry or are tied to specific risks and industry events. With the enactment of new laws and regulations and the issuance of additional guidance, the scope of supervisory activities and examinations are revised to promote the safety and soundness of banks and to assess compliance with laws and regulations.

Section 10(d) of the Federal Deposit Insurance Act generally requires the appropriate federal banking agency for an insured depository institution (which includes state member banks) to conduct a full-scope examination at least once every 12 months. The Act does permit a longer cycle—at least once every 18 months—for insured depository institutions that meet certain criteria. Examiners use the Uniform Financial Institutions Rating System (UFIRS), which is commonly referred to as the CAMELS rating system, to structure their assessment of a bank's condition and to communicate their conclusions about the assessment of a bank's condition.

PURPOSE OF THIS MANUAL

One of the main goals of the *Commercial Bank Examination Manual* is to explain the Federal Reserve's examination process for state member banks. The state member bank examination process is the Federal Reserve's fact-finding arm in carrying out its regulatory and supervisory responsibilities. Further, the Federal Reserve supplements the information from examination activities with information from its off-site surveillance process that is based on banks' financial regulatory reports (referred to as the "Call Reports").

Objectives of an Examination

The essential objectives of an examination are to (1) provide an objective evaluation of a bank's soundness; (2) determine the level of risk involved in the bank's transactions and activities; (3) ascertain the extent of compliance with banking statutes and regulations; (4) evaluate the adequacy of corporate governance and to appraise the quality of the board of directors and management; and (5) identify the activities and business operations where a bank needs to take corrective action to improve its risk management, the quality of its performance, and to promote and demonstrate compliance with applicable statutes and regulations.

The *Commercial Bank Examination Manual* organizes and formalizes examination objectives and procedures that provide guidance to examiners on conducting their work, and enhances the quality of examinations and consistent application of procedures across the Federal Reserve System. The manual provides specific guidelines for

- determining the scope of an examination;
- determining the procedures to be used in examining a bank, including those procedures that may lead to the early detection of trends and risks that, if continued, might result in a deterioration in the condition of a bank;
- evaluating the adequacy of a bank's policies and procedures, the degree of compliance with them, and the adequacy of its internal controls;
- evaluating the work performed by a bank's internal and external auditors;

- evaluating the performance and activities of a bank's board of directors and management;
- preparing workpapers that support examination reports and aid in evaluating the work of examiners; and
- using objective criteria as a basis for the overall supervisory conclusion, comments, and criticism, regarding the condition of a bank, compliance with banking laws and regulations, and the quality of a bank's risk management.

This manual also provides background information on common banking activities and describes risk management practices for banks to support their safe and sound operations. More specifically, this manual describes loan and investment portfolio management as well as capital adequacy and liquidity analysis.

Although this manual is designed to provide guidance to examiners in planning and conducting bank examinations, it should not be considered a legal reference. Questions concerning the applicability of, and compliance with, banking laws and regulations should be referred to appropriate legal counsel at the Reserve Banks or the Board of Governors of the Federal Reserve System. As this manual provides background and references to regulations, a bank should refer to the Code of Federal Regulation for the Federal Reserve Board's regulations.

Further, this manual should not be viewed as a comprehensive training guide for examiners. Examiners should view this manual as a working tool and guide. The Federal Reserve has separate training and continuing professional development programs for its examiners and has examination modules that provide more detailed instructions than this manual to assist examiners in conducting an examination.

HOW TO USE THIS MANUAL

Organization

The *Commercial Bank Examination Manual* is divided into the following major parts, which are generally organized based on the components of the CAMELS rating system:

- Part 1000—Supervisory Process
- Part 2000—Assets
- Part 3000—Capital, Earnings, Liquidity, and Sensitivity to Market Risk
- Part 4000—Management Activities and Internal Controls
- Part 5000—Other Examination Areas
- Part 6000—Bank Regulations
- Part 7000—International
- Part 8000—Statutes Administered by the Federal Reserve

Sections in each part are made up of four subsections, where applicable:

- *Supervisory policy and guidance by topic* (e.g., section xxxx.1): These sections provide details on the respective topics. This information is expanded upon and reinforced through the Federal Reserve's educational and training programs and the examiner's experience on the job.
- *Examination objectives* (e.g., section xxxx.2): These sections describe the goals that examiners should achieve in performing the examination for a particular bank activity or risk. In some instances, the examination objectives are incorporated into the examination procedures or are part of the Examination Documentation (ED) modules, which define common examination objectives and procedures for the review of state member banks in the community and regional bank supervision portfolios. Therefore, a manual section may not have an examination objectives section.
- *Examination procedures* (e.g., section xxxx.3): These sections list procedures that examiners may scope into the review of a bank's activity or risk. If there are corresponding ED modules for the topic, the section will provide a link to the ED modules page on the Board's public website and a listing of module titles related to the section.
- *Internal control questionnaires* (e.g., section xxxx.4): These sections set forth standards for a bank's operational controls. The assessment of a bank's internal controls is typically incorporated into the examination procedures and, therefore, a manual section may not have an internal control questionnaire (ICQ). An ICQ can be used in evaluating a bank's operational audit techniques where the scope of internal audit includes such considerations. The ICQ steps marked with an asterisk require substantiation by observation or testing.

UPDATES

Effective December 31, 2017, the Board ended the option of ordering print versions for the *Commercial Bank Examination Manual*. The manual is updated periodically. The most recent version of the entire manual and major sections, as well as the ED modules, are available on the Board's website at https://www.federalreserve.gov/publications/supmanual.htm.

1000—SUPERVISORY PROCESS

The 1000 series of sections explain the Federal Reserve's methodology for supervising state member banks of various asset sizes. These sections describe how examiners assess the safety and soundness of state member banks using the Uniform Financial Institution Rating System or CAMELS (**C**apital, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity, and **S**ensitivity to Market Risk) rating system.

INTRODUCTION

The Federal Reserve shares supervisory and regulatory responsibility for domestic banks with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) at the federal level, and with individual state banking departments at the state level. The Federal Reserve is the primary federal supervisor of state-chartered banks that have chosen to join the Federal Reserve System. Such domestically operating banks are called state member banks (SMBs).

Regulation and supervision are distinct, but complementary, activities. Regulation entails establishing the rules within which financial institutions must operate—in other words, issuing specific regulations governing the formation, operations, activities, and acquisitions of financial institutions. Once the rules and regulations are established, supervision—which involves monitoring, inspecting, and examining financial institutions—seeks to ensure that an institution complies with those rules and regulations, and that it operates in a safe-and-sound manner.

Section 39 of the Federal Deposit Insurance Act[1] (FDI Act) requires each federal banking agency to establish certain safety-and-soundness standards by regulation or by guideline for all insured depository institutions. In accordance with section 39, the agencies' guidelines cover three types of standards: (1) operational and managerial standards; (2) compensation standards; and (3) such standards relating to asset quality, earnings, and stock valuation as they determine to be appropriate.[2] The safety-and-soundness standards that the agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The agencies believe that the interagency standards for safety and soundness serve this end without dictating how institutions must be managed and operated. These standards are designed to identify potential safety-and-soundness concerns and ensure that action is taken to address those concerns before they pose a risk to the deposit insurance funds.

As the primary federal supervisor for SMBs (as well as bank holding companies, savings and loan holding companies, intermediate holding companies, and other banking entities), the Federal Reserve can take formal enforcement actions against these institutions for violations of laws, rules, or regulations, unsafe or unsound practices, breaches of fiduciary duty, and violations of final orders.

The purpose of this section is to describe key aspects of the Federal Reserve's supervisory program for safety-and-soundness examinations that are relevant to SMBs. Subsequent sections in this manual will further describe the examination and supervisory process of SMBs by supervisory portfolio, which is based on the banks' complexity, activities, asset size, and financial and operational risk factors.

1. 12 U.S.C. 1831p-1.
2. See 12 CFR 208, appendix D-1.

EXAMINATION AND SUPERVISORY AUTHORITY

The Federal Reserve System's statutory examination authority permits examiners to review all books and records maintained by a financial institution that is subject to the Federal Reserve's supervision. This authority extends to all documents.[3] Section 11(a)(1) of the Federal Reserve Act provides that the Board has the authority to examine, at its discretion, the accounts, books, and affairs of each member bank and to require such statements and reports as it may deem necessary. Therefore, Federal Reserve supervisory staff (including examination staff), may review *all* books and records of a banking organization that is subject to Federal Reserve supervision.[4]

CONFIDENTIALITY PROVISIONS

The complete definition of confidential supervisory information (CSI) is in 12 CFR pt. 261, subpart C. Generally, CSI consists of any documents prepared by Federal Reserve staff that

3. Supervision and Regulation SR-97-17, "Access to Books and Records of Financial Institutions During Examinations and Inspections," details the procedure supervisory staff should follow if a banking organization declines to provide information asserting a claim of legal privilege.
4. Supervisory staff include Federal Reserve staff who are conducting supervisory activities during the on-site examination and in connection with examination preparation, monitoring, and surveillance activities that are conducted off-site from a supervised institution's offices.

contains supervisory views regarding a supervised institution, or confidential information obtained from a supervised institution. These include examination reports, operating and condition reports (from continuous monitoring, for example), and information related to, derived for, or contained in such reports. Information gathered in the course of investigations related to enforcement actions is also CSI.

Importantly, CSI does not include "documents prepared by a supervised firm for its own business purposes and that are in its possession." (Refer to 12 CFR 261.2(b)(2)(i).) This means that a supervised firm may share information that was submitted to the Federal Reserve with third parties so long as that information was not produced specifically for the Federal Reserve and does not contain any information that suggests supervisory views or supervisory actions communicated to the supervised firm by the Federal Reserve.

Under the Board's Rules Regarding the Availability of Information (12 CFR 261), banking organizations are prohibited from disclosing confidential supervisory information without prior written permission of the Board's General Counsel.[5] Board staff have taken the position that identification of information requested by, or provided to, supervisory staff—including the fact that an examination has taken or will take place—is related to an examination and falls within the definition of confidential supervisory information.

Confidentiality Provisions in Agreements that Prevent or Restrict Notification to the Federal Reserve

The Federal Reserve has stated and clarified its expectations regarding confidentiality provisions that are contained in agreements between a banking organization and its counterparties (for example, mutual funds, hedge funds, and other trading counterparties) or other third parties. It is contrary to Federal Reserve regulation and policy for agreements to contain confidentiality provisions that (1) restrict the banking organization from providing information to Federal Reserve supervisory staff (refer to 12 U.S.C. 1820(d)); (2) require or permit, without the prior approval of the Federal Reserve, the banking organization to disclose to a counterparty that any information will be or was provided to Federal Reserve supervisory staff; or (3) require or permit, without the prior approval of the Federal Reserve, the banking organization to inform a counterparty of a current or upcoming Federal Reserve examination or any nonpublic Federal Reserve supervisory initiative or action. Banking organizations that have entered into agreements containing such confidentiality provisions are subject to legal risk. See SR-07-19, "Confidentiality Provisions in Third-Party Agreements," and SR-97-17, "Access to Books and Records of Financial Institutions During Examinations and Inspections," for more information. For information on the restrictions pertaining to the very limited disclosure of confidential supervisory ratings and other nonpublic supervisory information, see SR-05-4, "Interagency Advisory on the Confidentiality of Nonpublic Supervisory Information," and SR-96-26, "Provision of Individual Components of Supervisory Rating Systems to Management and Boards of Directors."[6]

OBJECTIVES OF THE SUPERVISORY PROCESS

The Federal Reserve is committed to ensuring that the supervisory process for all institutions under its purview meets the following objectives:

- *Provides flexible and responsive supervision.* The supervisory process is dynamic and forward-looking, so it responds to technological advances, product innovation, and new risk-management systems and techniques as well as to changes in the condition of an individual financial institution and to market developments.
- *Fosters consistency, coordination, and communication among the appropriate supervisors.* Seamless supervision, which reduces regulatory burden and duplication, is promoted. Examiners review the institution's risk assessments, key control functions, and monitoring systems. Federal Reserve examiners conduct joint examinations with other federal banking agencies and alternate examinations with state bank supervisors. Examiners tailor

5. 12 CFR 261.20(a).

6. See also this manual's section, "Overall Conclusions Regarding Condition of the Bank."

supervisory activities to an institution's condition, risk profile, and unique characteristics.

- *Promotes the safety and soundness of financial institutions.* The supervisory process effectively evaluates the safety and soundness of banking institutions, including assessing risk-management systems and financial condition as well as determining compliance with laws and regulations.
- *Provides a comprehensive assessment of the institution.* The supervisory process integrates "specialty" areas (for example, information technology, trust, Bank Secrecy Act (BSA)/anti-money laundering (AML), and consumer compliance) and functional risk assessments and reviews, in cooperation with interested supervisors, into a comprehensive assessment of the institution.

RISK-FOCUSED EXAMINATIONS

The Federal Reserve began to further emphasize the importance of sound risk-management processes and strong internal controls in the mid-1990s when evaluating the activities of SMBs. (See SR-96-14, "Risk-focused Safety and Soundness Examinations and Inspections," and SR-95-51, "Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.") To ensure that institutions have in place the processes necessary to identify, measure, monitor, and control their risk exposures, Federal Reserve supervisory activities focus on evaluating the appropriateness of a bank's risk management practices and processes. Under a risk-focused examination approach, examiner resources are focused on a bank's highest risk areas. However, when examiners find weakness in a bank's risk-management processes or internal controls, such as an inadequate loan review function, examiners would increase the sample of loans to review or will perform additional loan transaction testing. In addition, if an examiner believes that a banking organization's management is being less than candid, has provided false or misleading information, or has omitted material information, then examiners will expand the scope of their on-site transaction testing.

The Federal Reserve recognizes that transaction testing by itself is not sufficient for ensuring the continued safe-and-sound operation of a banking organization. Evolving financial instruments and markets have enabled banking organizations to rapidly reposition their risk exposures. Therefore, periodic assessments of the condition of a financial institution that are based on transaction testing alone cannot keep pace with the moment-to-moment changes occurring in a bank's risk profile.

The examination approaches for both community banks and large banks are risk-focused processes that rely on an understanding of the institution, the performance of risk assessments, the development of a supervisory plan or examination scope, and examination procedures tailored to the institution's risk profile. However, the Federal Reserve has tailored its supervisory approach for a large bank versus a community bank. The process for large institutions relies more heavily on a dedicated supervisory team with central points of contact and supervisory plans consisting of various activities such as continuous monitoring activities, target reviews, or horizontal supervisory activities. In comparison, for community banks, the Federal Reserve conducts a point in time examination, which is supplemented by off-site surveillance monitoring. The Federal Reserve's supervisory approach differs for community banks versus larger more complex banks to address differences in banks' activities, operations, and risk profiles. In comparison to community banks, large complex banks typically have more financial products, sophisticated risk-management systems (including audit and internal controls), greater management structure, and a wider geographic dispersion of operations.

COMPLIANCE WITH LAWS AND REGULATIONS

Compliance with relevant laws and regulations should be assessed during the examination process. The steps taken to complete these assessments will vary depending on the circumstances of the institution subject to review. When an institution has a history of satisfactory compliance with relevant laws and regulations or has an effective compliance function, only a relatively limited degree of transaction testing need be conducted to assess compliance. At institutions with a less satisfactory compliance record or that lack a compliance function, more extensive review will be necessary.

Role of Supervisory Guidance

The Federal Reserve and the other agencies issue various types of supervisory guidance, including interagency statements, advisories, bulletins, policy statements, questions and answers, and frequently asked questions, to their respective supervised institutions. A statute or regulation has the force and effect of law.[7] Unlike a law or regulation, supervisory guidance does not have the force and effect of law, and the agencies do not take enforcement actions based solely on supervisory guidance. Rather, supervisory guidance outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area. Supervisory guidance often provides examples of practices that the agencies generally consider consistent with safety-and-soundness standards or other applicable laws and regulations, including those designed to protect consumers. See 12 CFR 262, Appendix A, "Statement Clarifying the Role of Supervisory Guidance."

APPLICATIONS UNDER REGULATION H: 12 CFR 208

Regulation H (12 CFR 208) defines the membership requirements for SMBs; describes membership privileges and conditions imposed on these banks; sets out procedures for requesting approval to establish branches and for requesting voluntary withdrawal from membership; provides information for registering and filing financial statements; sets out procedures for dealing with banks that are less than adequately capitalized; and establishes real estate lending standards. Below is description of various applications SMBs file under Regulation H.

Bank Merger

A bank must file an application for prior Federal Reserve approval under section 18(c) or section 5(d)(3) of the FDI Act to merge with another bank or thrift institution, respectively, or to acquire the assets, or assume the liabilities, of another bank or thrift institution, if the resulting institution is to be an SMB.

7. Government agencies issue regulations that generally have the force and effect of law. Such regulations generally take effect only after the agency proposes the regulation to the public and responds to comments on the proposal in a final rulemaking document.

Bank Service Company

An SMB must file an application for prior Federal Reserve approval under section 5(a) of the Bank Service Company Act (BSC Act) to invest in or establish a bank service company if the company would engage in activities under sections 4(c), 4(d), or 4(e) of the BSC Act. A bank (regardless of its charter) must file an application for prior Federal Reserve approval under section 5(b) of the BSC Act to invest in or establish a bank service company if the company would engage in activities under sections 4(b) or 4(f) of the BSC Act.

Change in Control

A person or a group acting in concert, as defined in Regulation Y (12 CFR 225.2), proposing to acquire voting shares of an SMB may be required to provide prior notice to the Federal Reserve in accordance with Regulation Y (12 CFR 225.43).

Domestic Branches

An SMB must file an application for prior Federal Reserve approval under Regulation H (12 CFR 208.6) to establish a new branch facility. An application must be filed, whether the branch is located in the state where the bank is headquartered (intrastate branch) or whether the branch is located in another state (interstate branch). In addition, applications for de novo interstate branches are subject to state filing requirements and to capital, management, and community reinvestment standards. See SR-11-3, "De Novo Interstate Branching by State Member Banks." See also, SR-13-7/CA-13-4, "State Member Bank Branching Considerations."

Section 109 of the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) (12 U.S.C. 1835a) prohibits any bank from establishing or acquiring a branch or branches outside of its home state primarily for the purpose of deposit production. In 1997, the banking agencies published a joint final rule implementing section 109. (See 62 *Fed. Reg.*

47728, September 10, 1997.) Section 106 of the Gramm-Leach-Bliley Act of 1999 expanded the coverage of section 109 of the Interstate Act to include any branch of a bank controlled by an out-of-state bank holding company. On June 6, 2002, the Board and the other banking agencies published an amendment to their joint final rule (effective October 1, 2002) to conform the uniform rule to section 109. (See 67 *Fed. Reg.* 38844.) The amendment expands the regulatory prohibition against interstate branches being used as deposit-production offices to include any bank or branch of a bank controlled by an out-of-state bank holding company, including a bank consisting only of a main office. See Regulation H, 12 CFR 208.7(b)(2).

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) modified the federal statute governing de novo interstate branching by SMBs. As a result, as of July 22, 2010, an SMB is authorized to open its initial branch in a host state[8] by establishing a de novo branch at any location at which a bank chartered by the host state could establish a branch.[9]

An SMB that desires to establish a new branch facility may be eligible for expedited processing of its application by the Reserve Bank if it is an eligible bank, as defined in Regulation H (12 CFR 208.2(e)).

A member bank also may choose to submit an application that encompasses multiple branches that it proposes to establish within one year of the approval date. Unless notification is waived, the bank must notify the appropriate Reserve Bank within 30 days of opening any branch approved under a consolidated application. The approval to open a branch is valid for one year. During this period, the Board or the appropriate Reserve Bank may notify the bank that in its judgment, based on reports of condition, examinations, or other information, there has been a change in the bank's condition, financial or otherwise, that warrants reconsideration of the approval. (See Regulation H, 12 CFR 208.6(d).)

Insured depository institutions that intend to close branches must comply with the requirements detailed in section 42 of the FDI Act (12 U.S.C. 1831r-1). Section 42(e) requires that banks provide 90 days' notice to both customers and, in the case of insured SMBs, the Federal Reserve Board before the date of the proposed branch closings. The notice must include a detailed statement of the reasons for the decision to close the branch, and statistical and other information in support of those stated reasons. A similar notice to customers must be posted in a conspicuous manner on the premises of the branch to be closed at least 30 days before the proposed closing. There are additional notice, meeting, and consultation requirements for proposed branch closings by interstate banks in low and moderate income areas. Finally, the law requires each insured depository institution to adopt policies for branch closings. (See the revised joint policy statement concerning insured depository institutions' branch closing notices and policies, effective June 29, 1999. See also 64 *Fed. Reg.* 34844.) Examiners and supervisors need to be mindful of the section 42 statutory requirements and this joint policy.

Regulation H (12 CFR 208.6(f)) states that a branch relocation, defined as a movement that occurs within the immediate neighborhood and does not substantially affect the nature of the branch's business or customers served, is not considered a branch closing. Further, Regulation H (12 CFR 208.2(c)(2)(ii)) states (in one of six exclusions) that a branch does not include an office of an affiliated or unaffiliated institution that provides services to customers of the member bank on behalf of the member bank, so long as the institution is not "established or operated" by the bank. For example, a bank could contract with an unaffiliated or affiliated institution to receive deposits; cash and issue checks, drafts, and money orders; change money; and receive payments of existing indebtedness without becoming a branch of that bank. The bank could also (1) have no ownership or leasehold interest in the institution's offices, (2) have no employees who work for the institution, and (3) not exercise any authority or control over the institution's employees or methods of operation.

Emergency Applications

Emergency conditions associated with a problem or failing banking organization may allow for processing of an application under the streamlined procedures of the Bank Holding Company

8. "Host state" means a state, other than a bank's home state, in which the bank seeks to establish and maintain a branch. 12 U.S.C. 36(g)(3)(C).

9. 12 U.S.C. 36(g)(1)(A), as amended by section 613(a) of the Dodd-Frank Act; 12 U.S.C. 321. Initial entry into a host state by way of an interstate bank merger is governed by 12 U.S.C. 1831u.

Act, the FDI Act, the Change in Bank Control Act, or the Federal Reserve Act.[10] The two types of emergency procedures are expeditious action and immediate action. Under the expeditious action procedures, the Federal Reserve allows the public up to 10 days to comment on a proposal. Under the immediate action procedures, the Federal Reserve would act on a proposal as soon as possible. Potential filers are encouraged to contact the Federal Reserve as early as possible to discuss emergency procedures.

Membership

A state-chartered bank proposing to become a member of the Federal Reserve System or a national bank converting to a state-charter and desiring to remain a member of the Federal Reserve System must file an application for prior Federal Reserve approval under of Regulation H (12 CFR 208.3).[11] A bank seeking membership should contact the Federal Reserve prior to submitting a final application to allow for the completion of a pre-membership examination, if needed.

Notice of Addition or Change in Directors or Senior Executive Officers

An SMB must provide prior notice to the Federal Reserve to add a director or a senior executive officer if the bank meets the criteria in Regulation Y (12 CFR 225.72). An institution may request a waiver of the prior notice requirement if the individual's services are needed immediately.

Premises Acquisition

An SMB must provide prior notice to the Federal Reserve under Regulation H (12 CFR 208.21) to increase its investment in bank premises if the aggregate of all such investments and loans, together with the amount of any indebtedness incurred by any corporation that is an affiliate of the bank, will be more than the bank's perpetual preferred stock and related surplus plus common stock and surplus. The filing threshold is raised to 150 percent of the bank's perpetual preferred stock and related surplus plus common stock and surplus if the proposal meets the conditions in Regulation H (12 CFR 208.21(a)(3)). See also this manual's section entitled, "Bank Premises and Equipment," for more information.

Changes in the General Character of a Bank's Business

In conjunction with assessing overall compliance with relevant laws and regulations, examiners should review for compliance with the requirements of Regulation H, which sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. Under the regulation, a member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership." (See SR-02-9, "Guidance Regarding Significant Changes in the General Character of a State Member Bank's Business and Compliance with Regulation H," and Regulation H (12 CFR 208.3(d)(1) and (2)).)

SMBs must receive the prior approval of the Board before making any significant change in business plans. The trend toward more diverse, more complex, and, at times, riskier activities at some banks has raised the importance of this prior-approval requirement. Changes in the general character of a bank's business would include, for example, becoming a primarily financial technology-based operation, or concentrating solely on subprime lending, mortgage lending, or leasing activities. Depending on how they are conducted and managed, these activities can present novel risks for banking organizations and may also present risks to the deposit insurance fund. In many cases, these activities in-

10. Emergency procedures cannot be used without a letter from the chartering authority of the failing financial institution.

11. A newly organized bank must apply directly to the FDIC for deposit insurance. The bank also should have received at least preliminary approval for a state banking charter prior to filing a final membership application with the Federal Reserve. A draft application may be submitted prior to state action on the charter.

volve aggressive growth plans and may give rise to significant financial, managerial, and other supervisory issues.

In applications for membership in the Federal Reserve System, the Federal Reserve considers a bank's proposed business plan to ensure, at a minimum, that appropriate financial and managerial standards are met. Likewise, the other federal banking agencies consider a bank's business plan when they review applications for federal deposit insurance, in the case of the FDIC, or applications for a national bank or federal thrift charter, in the case of the OCC. The OCC and the FDIC may condition their approvals of applications on a requirement that, during the first three years of operations, the bank or thrift provides prior notice or obtains prior approval of any proposed significant deviations or changes from its original operating plan. Rather than use similar commitments, the Federal Reserve has relied on the provisions of Regulation H to address situations in which an SMB proposes to materially change its core business plan.

Federal Reserve supervisors should monitor changes in the general character of an SMB's business as part of the Federal Reserve's normal supervisory process to ensure compliance with the requirements of Regulation H and with safe-and-sound banking practices. This review should be conducted by the Reserve Bank during the on-site examination of the bank. A significant change in a bank's business plan without the Board's prior approval would be considered a violation of Regulation H and would be addressed through follow-up supervisory action.

Minimum Statewide Loan-to-Deposit Ratios

Section 109 of the Interstate Act sets forth a process to test compliance with the statutory requirements. First, a bank's statewide loan-to-deposit ratio[12] is compared with the host-state loan-to-deposit ratio[13] for banks in a particular state. If the bank's statewide loan-to-deposit ratio is at least one-half of the published host-state loan-to-deposit ratio, then it has complied with section 109 of the Interstate Act. A second step is conducted if a bank's statewide loan-to-deposit ratio is less than one-half of the published ratio for that state or if data are not available at the bank to conduct the first step. The second step involves determining whether the bank is reasonably helping to meet the credit needs of the communities served by its interstate branches. If a bank fails both of these steps, it has violated section 109 of the Interstate Act and is subject to sanctions.

RATING THE BANK

Uniform Financial Institutions Rating System

All of the federal banking agencies use the Uniform Financial Institutions Rating System (UFIRS), commonly referred to as the "CAMELS" rating system, as the criteria for rating a bank or thrift. The agencies under the auspices of the Federal Financial Institutions Examination Council (FFIEC) last revised this rating system in 1996. Under the UFIRS, each financial institution, more specifically an insured depository institution whose primary federal supervisory agency is represented on the FFIEC, is assigned a composite rating based on an evaluation and rating of six essential components of an institution's financial condition and operations. These component factors address the "C"—adequacy of capital; "A"—the quality of assets; "M"—the capability of management; "E"—the quality and level of earnings; "L"—the adequacy of liquidity; and "S"—the sensitivity to market risk.[14]

Evaluations of the components take into consideration the institution's asset size and sophistication, the nature and complexity of its activities, and its risk profile. Composite and component ratings are assigned based on a "1 to 5" numerical scale. A "1" indicates the highest rating, strongest performance and risk management practices, and least degree of supervisory concern, while a "5" indicates the

12. The statewide loan-to-deposit ratio relates to an individual bank and is the ratio of a bank's loans to its deposits in a particular state where the bank has interstate branches.

13. The host-state loan-to-deposit ratio is the ratio of total loans in a state to total deposits from the state for all banks that have that state as their home state. For state-chartered banks, the home state is the state where the bank was chartered.

14. For a full description of the CAMELS component, see the manual section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating."

lowest rating, weakest performance, inadequate risk management practices and, therefore, the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors comprising that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and to address the risks that may arise from changing business conditions, or the initiation of new activities or products, is an important factor in evaluating a financial institution's overall risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating. The ability of management to identify, measure, monitor, and control the risks of its operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-today activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Risk Management Rating

The Federal Reserve instituted an explicit risk management rating requirement to be assigned for examinations and inspections commencing on or after January 2, 1996. The risk management rating applies to all SMBs, regardless of their size.[15]

The rating for risk management is based on a scale of one through five in ascending order of supervisory concern. Examiners should assign this rating to reflect findings within all four elements of sound risk management:

- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk measurement, monitoring, and management information systems
- comprehensive internal controls

The risk management rating should be reflected in the overall "Management" rating of the institution and should be consistent with the ratings criteria discussed in the section entitled, "Condition of the Bank: Uniform Financial Institutions Rating System."

Definition of a Full-Scope Examination

The definition of a full-scope examination includes the safety-and-soundness components of the Interagency Uniform Rating System for CAMELS, the safety-and-soundness mandates of the Federal Deposit Insurance Corporation Improvement Act of 1991 and other regulatory priorities. A full-scope examination involves the collection and analysis of data sufficient to allow the examiner-in-charge (EIC) to determine a rating for each of the CAMELS components. To make this determination the EIC should ensure various financial and managerial factors are considered during the full-scope examination. It is expected that a full-scope examination would

15. This rating requirement was introduced by SR-95-51. See also SR-16-11 and the manual section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System" and the Federal Reserve's Risk Management Rating.

be conducted on a consolidated basis, meaning that all subsidiaries of the bank would be evaluated. The scope of analysis of subsidiaries and the necessity for on-site presence in such subsidiaries and branches of the banking institution should be determined by the EIC after an analysis of the materiality and operational risk inherent in each. In most cases, an on-site examination of material credit extending (issuing) subsidiaries should be conducted. For more information on the minimum expectations for full-scope examinations see SR-94-12, "The Federal Reserve System's Definition of a Full Scope, On-Site Examination for Safety and Soundness."

Target Examinations

Target examinations focus intensively on one or two activities rather than assessing all of the safety-and-soundness components of the CAMELS rating system. There are multiple circumstances when the Federal Reserve would conduct a target examination. For instance, if the bank is under a formal enforcement action, compliance with the formal action may be validated, in part, through a target examination. In addition, the Federal Reserve may conduct a target examination of a particular activity, such as the bank's loan review, between full-scope examinations if off-site monitoring noted deteriorating asset quality at the bank. For more information, see discussion below on SMB examination frequency and coordination.

OTHER EXAMINATION AREAS

Foreign branch and specialty examination findings and the ratings assigned to those areas are taken into consideration, as appropriate, when assigning component and composite ratings under UFIRS. Several specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.[16]

16. See the manual section entitled "Other Examination Areas" for more information on the specialty examination areas.

EXAMINATION-FREQUENCY EXPECTATIONS FOR STATE MEMBER BANKS

The Federal Reserve is required to conduct a full-scope, on-site examination of every insured SMB at least once during each 12-month period, with the exception that certain small institutions can be examined once during each 18-month period. The 18-month examination period can be applied to those banks that

- have total assets of less than $3 billion;
- are well capitalized;
- the Federal Reserve assigned a management component rating of "1" or "2" at the most recent Federal Reserve or applicable state banking agency examination;[17]
- were assigned a CAMELS composite rating of "1" or "2" as part of the bank's rating;[18]
- are not subject to a formal enforcement proceeding or action by the Federal Reserve or the FDIC; and
- no person acquired control of the bank during the preceding 12-month period in which a full-scope examination would have been required but for the 18-month examination cycle eligibility provision.[19]

The exceptions do not limit the authority of the Federal Reserve to examine any insured member bank as frequently as deemed necessary. The examination cycle was also expanded from 12 months to 18 months for U.S. branches and agencies of foreign banks, subject to specified qualifying criteria. (Refer also to SR-18-7, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations."

17. The Board is permitted to conduct on-site examinations of SMBs on alternating 12-month or 18-month periods with the institution's state supervisor, if the Board determines that the alternating examination conducted by the state carries out the purposes of section 10(d) of the FDI Act. 12 U.S.C. 1820(d)(3). Refer to the discussion below on the Alternate-Year Examination Program.

18. The ratings were assigned under the Uniform Financial Institutions Rating System (UFIRS). Refer to SR-96-38, "Uniform Financial Institutions Rating System," and this manual's section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating."

19. 12 CFR 208.64.

Bank Secrecy Act/Anti-Money Laundering Examination Frequency

The Federal Reserve is required to complete a BSA/AML compliance program review at each safety-and-soundness examination conducted at an SMB or U.S. branch or agency of a foreign bank, which is typically every 12 months.[20] However, Reserve Banks should conduct a BSA/AML compliance program review every 18 months if the SMB or U.S. branch or agency of a foreign bank is eligible for and is examined on the 18-month examination cycle. See SR-18-7 for more information.

20. 12 U.S.C. 1818(s)(2) and 12 U.S.C. 1818(b)(4).

Table 1. Overview of State Member Bank Examination Frequency and Coordination[1]

Total Asset Size of the State Member Bank (SMB)[2]	*Composite CAMELS rating of "1" or "2" from the last examination*	*Composite CAMELS rating of "3" from the last examination*	*Composite CAMELS rating of "4" or "5" from the last examination*
$0 to less than $3 billion	Full-scope on-site exam every 18 months, provided: • SMB is well capitalized; • SMB received a CAMELS composite rating of "1" or "2" and a management component rating of "1" or "2" at the most recent Federal Reserve or applicable state banking agency examination; • SMB not subject to a formal enforcement proceeding or order by Federal Reserve or FDIC; and • No person acquired control of the SMB during the preceding 12-month period in which a full-scope exam would have been required but for the 18-month exam cycle. Otherwise, full-scope on-site exam every 12 months. May be eligible for alternate-year examination program (AEP).[3]	Full-scope on-site exam every 12 months conducted by the Federal Reserve or jointly with the relevant state banking agency. A targeted exam conducted by the Federal Reserve or jointly with the state banking agency is also required annually for deteriorating institutions.[4]	Two exams are required every 12 months. One of the two exams must be a full-scope exam. Both exams must be conducted by the Federal Reserve or jointly with the relevant state banking agency.
$3–$10 billion	Full-scope on-site exam every 12 months. May be eligible for AEP.		
$10 billion or more and less than $100 billion	Full-scope on-site exam every 12 months. Some SMBs rated CAMELS composite "1" and "2" may be eligible for an AEP. The SMB is subject to continuous monitoring, and exam activities are intensified based on the severity of issues at the bank.		
$100 billion and above	Full-scope on-site exam every 12 months. The full-scope exam must be led by the Federal Reserve and may be joint with the relevant state banking agency. The SMB is subject to continuous monitoring, and exam activities are intensified based on the severity of issues at the bank.		

1. This table provides a brief summary of examination (exam) frequency requirements for SMBs. See the Federal Reserve Board's Regulation H, (12 CFR 208.64(b)).
2. Examinations of SMBs with $10 billion or more in total assets are typically integrated into the consolidated supervision program at the bank holding company.
3. AEPs generally allow exams conducted in alternating years or alternating 18-month periods, as appropriate, to be conducted by the state banking agency. For those SMBs with total assets over $3 billion, there must be a Federal Reserve examiner presence at state-led AEP exams. AEPs are implemented on a state-by-state basis. Consult the appropriate Reserve Bank for further information regarding eligibility and availability of an AEP in a particular state.
4. The Federal Reserve typically identifies deteriorating banks through off-site surveillance information. See this manual's section entitled, "Federal Reserve System Bank Surveillance Program," for more information.

De Novo Bank Examination Frequency and Scope

A de novo bank is a bank that has been in operation for three years or less. A de novo bank or a recently converted SMB has a different examination frequency from the required 12-month or 18-month examination schedule. The examination frequency for these banks is found in SR-20-16, "Supervision of De Novo State Member Banks."[21]

Within the first six months following a de novo's formation or conversion to a state member bank, the responsible Reserve Bank should conduct a targeted examination. In a written report provided to the bank's board of directors and senior management, the Reserve Bank should summarize the scope of review and supervisory findings but should generally not assign a CAMELS rating.

The responsible Reserve Bank should conduct a full-scope examination, independently, jointly, or concurrently with the state banking department within 12 months of the de novo's formation or its conversion to a state member bank. Thereafter, the bank should remain on a 12-month cycle until two full-scope, on-site examinations have been conducted. After the bank (1) has had three full-scope examinations, and (2) has been in operation for three years, the Reserve Bank may transition to the statutorily required full-scope examination schedule.

After the initial target examination, the next three examinations of the de novo, either led by the Federal Reserve or conducted jointly with the state banking department, should be full-scope. In addition to the supervisory expectations for a full-scope examination, the Reserve Bank should review the de novo for certain capital and managerial related items, which are outlined in SR-20-16.

De Novo Subsidiaries of Bank Holding Companies with Assets Greater than $3 Billion

A Reserve Bank may elect to make a risk-based determination that a de novo that is a subsidiary of a bank holding company with consolidated assets of greater than $3 billion should be examined less frequently than otherwise suggested in SR-20-16 if, in the opinion of the Reserve Bank, the parent company and its subsidiary banks are in satisfactory condition and the parent is considered to be a source of strength to its insured depository institution subsidiaries. Such subsidiary de novos would be expected to maintain capital levels that align with the de novo policy guideline outlined in SR-20-16.

EXAMINATION OF INSURED DEPOSITORY INSTITUTIONS PRIOR TO MEMBERSHIP OR MERGER INTO STATE MEMBER BANKS

A safety-and-soundness or consumer compliance examination of a state nonmember bank, national bank, or savings association seeking to *convert its status to a state member* will not generally be required prior to the conversion if the institution seeking membership meets the criteria for "eligible bank," as set forth in the Board's Regulation H,[22] plus the additional safety-and-soundness and consumer compliance criteria listed below (together referred to as "eligibility criteria").[23] To meet the Regulation H "eligible bank" criteria, an insured depository institution must

1. be well capitalized under Regulation H, subpart D, Prompt Corrective Action;
2. have a composite CAMELS rating of "1" or "2";
3. have a Community Reinvestment Act (CRA) rating of "outstanding" or "satisfactory";

21. SR-20-16 applies to any commercial bank, thrift, Edge Act corporation, or industrial bank that has been in existence for less than three years and is converting to become a state member bank. Insured depository institutions that are in operation for longer than three years and apply to become a state member bank are not covered in SR-20-16 but may be subject to a pre-membership examination as outlined in SR-15-11/CA-15-9, "Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank."

22. 12 CFR 208.2(e).

23. Note that a bank may be subject to a consumer compliance pre-membership or pre-merger examination or CRA review even if it meets all waiver eligibility criteria for safety-and-soundness examination. Similarly, a pre-membership or pre-merger safety-and-soundness examination may be warranted even though the bank meets all of the waiver criteria for consumer compliance and/or CRA.

4. have a consumer compliance rating of "1" or "2"; and
5. have no major unresolved supervisory issues outstanding (as determined by the Board or appropriate Federal Reserve Bank in its discretion), including adverse supervisory findings or ratings by the current primary regulator or Consumer Financial Protection Bureau (CFPB).[24]

In addition, the insured depository institution seeking membership must meet the following additional safety-and-soundness criteria:

- the management component of CAMELS is rated "1" or "2"
- the on-site "close date" of the most recent full-scope safety-and-soundness examination is less than nine months from the date of the application for membership[25]
- there have been no material changes to the bank's business model since the most recent report of examination and no material changes are planned for the next four quarters[26]
- the annual growth in total assets, measured as of the most recent quarter end on the institution's Consolidated Reports of Condition and Income, is under 25 percent and planned growth over the next year is less than 25 percent

In cases where a state nonmember bank, national bank, or savings association is *merging with an SMB* and the surviving institution is an SMB, a safety-and-soundness or consumer compliance examination of the state nonmember bank, national bank, or savings association will not be required so long as the SMB meets all of the eligibility criteria on an existing and pro-forma basis. For example, the SMB would not meet all of the eligibility criteria if its total assets were to increase by 25 percent or more on a pro-forma basis considering both organic growth and assets from the merging institution. Other examples of situations that may cause the merging SMB to not meet the eligibility criteria include, but would not be limited to, a change in senior leadership, a change in strategy, and a situation where the institution with which it is merging is rated less than satisfactory, has major unresolved supervisory issues, or brings new business lines or products to the SMB. (See SR-15-11/CA-15-9, "Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank.")

Process for Determining Whether to Waive a Safety-and-Soundness Examination

In all cases, the Reserve Bank must consult with Board supervisory staff when determining whether to waive a safety-and-soundness examination under this policy. Under certain circumstances, a pre-merger or pre-membership examination may be waived even when an institution fails to meet one or more of the safety-and-soundness related eligibility criteria. This can occur if the Reserve Bank, in consultation with Board supervisory staff, determines that conducting a safety-and-soundness examination would be unlikely to provide information that would assist in evaluating the statutory and regulatory factors that the Federal Reserve is required to consider in acting on the membership or merger application.

Process for Determining Whether to Waive a Consumer Compliance Examination or CRA Review

For consumer compliance and CRA, the Reserve Bank should review the most recent supervisory information, including consumer compliance examinations, reviews, and risk assessments, from the appropriate primary banking regulatory agency and the CFPB, if applicable, and consult with applications staff and supervisory staff in the Board's Division of Consumer and Community Affairs (DCCA) when determining whether to waive a consumer compliance examination

24. In general, if significant trust or fiduciary activities were found to be conducted in a less-than-satisfactory manner, an insured depository institution would typically not meet this requirement.

25. The close date of an on-site examination is defined as the last date that the examination team is physically on-site at the institution. For examinations for which all or a portion of the work is performed off-site, the close date is defined as the earlier of the following dates: (1) the date when the analysis (including loan file review) is completed and ready for the examiner-in-charge review; or (2) the date when the preliminary exit meeting is held with management, which can be conducted either on-site or off-site by conference call.

26. A "material change" would be an event that would materially affect the institution's balance sheet and income statement, such as a sizeable growth, sale, or wind-down of a major business line or assets, or change in senior leadership positions, such as the chief executive officer, the chief financial officer, or the chairman of the board.

under this policy. However, if the institution seeking to convert to an SMB is rated less-than-satisfactory for consumer compliance, a pre-membership or pre-merger examination should be conducted.

In addition, if the review of supervisory information from the appropriate primary banking regulatory agency and the CFPB, if applicable, identifies significant weaknesses, a pre-membership or pre-merger consumer compliance examination may be warranted, with a focus on the particular area of concern, even if a bank has a consumer compliance examination rating of "1" or "2."[27] In such cases, the Reserve Bank should also consult with applications and supervisory staff in DCCA.

Because membership in the Federal Reserve System does not confer deposit insurance, CRA does not, by its terms, apply to membership applications. Nevertheless, a less-than-satisfactory CRA rating, especially if it reflects a chronic record of weak CRA performance, would presumably reflect unfavorably upon the abilities of management of the institution. In these situations, it is appropriate for the Reserve Bank to include in the pre-membership examination a review of the institution's CRA performance as well as management's plans and programs to ensure that the organization meets its CRA obligations going forward.

Documentation Requirement for a Waived Safety-and-Soundness or Consumer Compliance Examination

The Reserve Bank must prepare and maintain documentation supporting its decision not to conduct a pre-membership or pre-merger safety-and-soundness or consumer compliance examination. Documentation should include a memorandum summarizing how the institution meets each of the eligibility criteria or a justification for the waiver for cases where the institution does not meet one or more of the eligibility criteria. The supporting memorandum should summarize the Reserve Bank's review of the two most recent full-scope safety-and-soundness and consumer compliance examinations conducted by the appropriate primary banking regulatory agency and, when applicable, the CFPB.

Scope and Documentation of the Safety-and-Soundness or Consumer Compliance Examination

All pre-membership or pre-merger safety-and-soundness or consumer compliance examinations can be risk focused and targeted, as appropriate, to the identified area(s) of weakness. Furthermore, the Reserve Bank is not required to issue a report to the institution; however, the review should be documented in a memorandum that is maintained together with the application documents.

To fulfill the examination requirement for an insured depository institution or savings association that is a subsidiary of a bank holding company or savings and loan holding company (hereafter referred to as holding company) with consolidated assets equal to or greater than $100 billion, the supervisory team will generally rely on information gathered through the existing continuous monitoring program. The team is also expected to consider findings from recent examinations that assessed specific risks, lines of business, or control functions, and from reviews such as the Comprehensive Capital Analysis and Review, the mid-cycle supervisory stress test for banks and holding companies, the holding company resolution plans, and the insured depository institution resolution plan. In the event the results of continuous monitoring and prior examinations do not provide the information necessary to assess specific areas of weakness, the supervisory team will conduct a targeted examination.

Supervisory Expectations Post-Merger or Charter Conversion

In all cases, the Reserve Bank remains responsible for adhering to the required frequency timeframes established by Federal Reserve policies and regulations for both safety-and-soundness and consumer compliance examinations. When the statutory deadline for the examination of an insured depository institution

27. Supervisory matters not captured in the examination rating could raise significant concerns that may warrant a pre-membership or pre-merger examination. Examples of such events that could raise serious concerns about consumer compliance include (1) a continuous monitoring event; (2) litigation; (3) investigations by other agencies, such as the Department of Justice, or the Department of Housing and Urban Development; and (4) other information—such as a spike in consumer complaints.

seeking membership is approaching, or has passed, a Reserve Bank should conduct an examination of the institution as soon as is practical after it becomes an SMB. The Reserve Bank should notify Board supervisory staff if the examination mandate will be missed for whatever reason.

In addition, for institutions with $10 billion or more in total consolidated assets, the Reserve Bank should complete the risk assessments and supervisory strategies required for safety-and-soundness no later than 30 days after the conversion or merger, regardless of whether the institution met the eligibility criteria. In preparing the risk assessment and supervisory strategy for an SMB that was formerly a savings association or that acquired a savings association, the Reserve Bank should pay particular attention to activities conducted by any service corporation subsidiary that may not be permissible for an SMB, where such activities have not yet been conformed.[28]

COORDINATION OF SUPERVISORY ACTIVITIES: COORDINATION WITH OTHER BANKING AGENCIES

Alternate-Year Examination Program

The frequency of examination also may be affected by the AEP. Under the AEP, those banks that qualify are examined in alternate examination cycles by the Reserve Bank and the state. Thus, a particular bank would be examined by the Reserve Bank in one examination cycle, the state in the next, and so on. Any bank may be removed from the program and examined at any time by either agency, and either agency can meet with a bank's management or board of directors or initiate supervisory action whenever deemed necessary. In general, banks with assets in excess of $10 billion and banks that are rated a composite 3 or worse are ineligible for an alternate-year examination. De novo state member banks are also ineligible for the AEP for the first three years of operations. (See SR-20-16.) For an SMB that has undergone a change in control and the state is scheduled to conduct the next examination, a Federal Reserve examiner should participate on the state-led AEP examination.

Guidelines for Relying on State Examinations

In 1995, the Federal Financial Institutions Examination Council (FFIEC) announced the adoption of Guidelines for Relying on State Examinations pursuant to section 349 of the Riegle Community Development and Regulatory Improvement Act of 1994.[29] One of the main reasons for issuing this guidance was to establish standards for the purpose of determining the acceptability of state reports of examination under section 10(d)(3) of the FDI Act, 12 U.S.C. 1820(d)(3).

The Federal banking agencies will accept and rely on state reports of examination in all cases in which it is determined that state examinations enable the federal banking agencies to effectively carry out their supervisory responsibilities. The following criteria may be considered, in whole or in part, by a federal banking agency when determining the acceptability of a state report of examination under section 10(d) of the FDI Act:

- The completeness of the state examination report. The state report of examination of a state-chartered, insured depository institution or a state-chartered branch or agency of a foreign bank should contain sufficient information to permit a reviewer to make an independent determination on the overall condition of the institution as well as each component factor and composite rating assigned under the "Uniform Financial Institutions Rating System" used for insured depository institutions and commonly referred to as the "CAMELS" rating system or the "ROCA" rating system used for branches and agencies of foreign banks.
- The adequacy of documentation maintained routinely by state examiners to support observations made in examination reports.

28. The Board, in acting on a membership application, is required to consider whether the corporate powers to be exercised are consistent with the purposes of the Federal Reserve Act (12 U.S.C. 322). In addition, Regulation H (12 CFR 208.3(d)(2)) requires a state member bank to obtain the Board's permission prior to changing the scope of powers it exercises.

29. 12 U.S.C. 1820(d)(9).

- The ability over time of a state banking department to achieve examination objectives. At a minimum, the federal banking agencies will consider the adequacy of state budgeting, examiner staffing and training, and the overall review and follow-up examination process of a state banking department. Accreditation of a state banking department by the Conference of State Bank Supervisors is among the factors that also will be considered.
- The adequacy of any formal or informal arrangement or working agreement between a state banking department and a federal banking agency.

The Federal banking agencies, as part of their routine review of state examination reports, will assess the quality and scope of the reports to determine whether they continue to meet the above general criteria. The Federal banking agencies retain the option in cases in which a state examination report appears insufficient or the condition of an insured institution, as indicated in the examination report or other sources, appears to be seriously deteriorating, to conduct a follow-up examination.

The appropriate Federal banking agency and state banking department will continue to share, discuss and work to resolve any problems or concerns regarding the acceptability of each other's work or the operation of these guidelines and the alternating examination program as well as other issues of mutual interest.

Ratings Assigned by State Supervisory Agencies under the Alternate Examination Program

Reserve Banks should review all state examination reports on banks included in the AEP. A Reserve Bank should only assign a separate CAMELS rating if there is disagreement with the rating assigned by the state supervisory agency that conducted the examination. In the event that a rating disparity exists, the rating assigned by the Reserve Bank and the rationale for that rating must be communicated to the board of directors of the affected institution and to the appropriate state and federal supervisory agencies.

The rating assigned by the state supervisory agency that conducted the examination should be entered into Federal Reserve systems of record as a full-scope examination. A different rating assigned by the Reserve Bank in connection with the AEP examination should be recorded as an "examination" event with a "supervisory assessment activity" scope. The Federal Reserve rating will serve as the basis for determining compliance with relevant statutes and regulations, and for the conduct of supervisory responsibilities, including supervisory and enforcement activities, the frequency of inspection/examination activity, and general surveillance activity. See SR-99-17, "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System," for more information.

Joint Examination Guidelines

The Nationwide State/Federal Supervisory Agreement, dated November 14, 1996, which addresses the supervision of multistate banking organizations, established guidelines for the conduct of joint examinations. Under the terms of the agreement, the participating state and federal supervisory agencies should make every effort to resolve significant differences that arise during a joint examination. If differences cannot be resolved, the agreement permits each supervisory agency to take action, independent of the other, in the fulfillment of its own statutory and supervisory responsibilities.

An examination should be considered a joint examination only if the participating supervisory agencies agree on the component and composite ratings to be assigned. If the Federal Reserve and the state supervisory agency disagree on the ratings to be assigned, the examination should be termed "concurrent," and should be recorded as such in the appropriate Federal Reserve system of record. In these instances, both the Federal Reserve rating and the state supervisory agency rating should be entered into the appropriate Federal Reserve system of record. In the event that an examination changes from "joint" to "concurrent" in the course of the examination, the examining Reserve Bank must assign a separate supervisory rating and issue a separate report of examination. The Federal Reserve rating will serve as the basis for determining compliance with relevant statutes and regulations, and for the conduct of its supervisory responsibilities, including supervisory and enforcement activities, the frequency of inspection/examination activity, and general surveillance activity.

Supervision of State-Chartered Banks

In May 2004, the State-Federal Working Group, an interagency group of state bank commissioners and senior officials from the Federal Reserve and the FDIC, developed a recommended-practices document designed to reiterate and reaffirm the need for a commonsense approach for collaborating with states in the supervision of state-chartered banking organizations.[30] The recommended practices highlight the importance of communication and coordination between state and federal banking agencies in the planning and execution of supervisory activities.

When communicating and coordinating with other agencies, examination and supervisory staff should follow the common courtesies and recommended practices identified in the May 2004 document. The recommended practices reinforce the long-standing commitment of federal and state banking supervisors to provide efficient, effective, and seamless oversight of state banks of all sizes, whether those institutions operate in a single state or more than one state. The recommended practices also minimize, to the fullest extent possible, the regulatory burden placed on state-chartered banks—thus further supporting and fostering a seamless supervisory process. (See SR-04-12, “Supervision of State-Chartered Banks.”)

30. The source for the recommended practices is the November 14, 1996, Nationwide State and Federal Supervisory Agreement to enhance the overall state-federal coordinated supervision program for state-chartered banks. The agreement established a set of core principles to promote coordination in the supervision of all interstate banks, with particular emphasis on complex or larger institutions. (See SR-96-33, “State/Federal Protocol and Nationwide Supervisory Agreement.”) These principles are equally applicable and important when supervisors from federal and state banking agencies are communicating and coordinating the supervision of state-chartered banks operating within a single state.

Recommended Practices for State Banking Departments, the FDIC, and the Federal Reserve

1. State and federal banking agencies should take steps to ensure that all staff responsible for the supervision and examination of state-chartered banks are familiar with the principles contained in the agreement. State and federal banking agencies should ensure that adherence to the principles in the agreement is communicated as a priority within their respective agencies at all levels of staff—ranging from the field examiners to the officers in charge of supervision and to state bank commissioners.
2. Home-state supervisors should make every effort to communicate and coordinate with host-state supervisors as an important part of supervising multistate banks as specified in the Nationwide Cooperative Agreement executed by the state banking departments and recognized by the federal agencies in the agreement.
3. State and federal banking agencies should consider inviting one another to participate in regional examiner training programs and/or seminars to discuss emerging issues and challenges observed in the banking industry.
4. Federal and state banking departments should maintain and share current lists of their staff members designated as primary contact persons (PCPs) for their institutions.
5. PCPs and EICs from the state banking department(s) and federal agencies should discuss and prepare supervisory plans at least once during the examination cycle, and more frequently as appropriate for institutions of greater size or complexity or that are troubled. The agencies should discuss and communicate changes to the plan as they may evolve over the examination cycle. The supervisory plans should be comprehensive, including examination plans, off-site monitoring, follow-up or target reviews, supervisory actions, etc., as applicable.
6. The PCPs from the home-state banking department and federal banking agencies should make every effort to share reports that their individual agencies have produced through their off-site monitoring program or through targeted supervisory activities.

7. State and federal banking agencies should notify one another as early as possible if their agency cannot conduct a supervisory event (e.g., examination) that was previously agreed upon—or if the agency intends to provide fewer examiners/resources than originally planned.
8. Meetings with bank management and directors should involve both the appropriate staff from the home-state banking department and from the responsible federal banking agency, whenever possible. If a joint meeting is not possible or appropriate (for example, the bank arranges the meeting with one agency only), the other agency (the home-state banking department or the responsible federal banking agency, as applicable) should be informed of the meeting.
9. The home-state and responsible federal agency should make every effort to issue a joint exam report in the 45-day time frame identified in the agreement. If circumstances prevent adherence to time frames identified in the agreement, the state and federal agencies should coordinate closely and consider benchmarks or timing requirements that may apply to the other agency.
10. All corrective action plans (for example, memoranda of understanding (MOU), cease-and-desist orders) should be jointly discussed, coordinated, and executed to the fullest extent possible among all examination parties involved. Also, all information on the institution's corrective action plan and progress made toward implementing the plan should be shared.
11. To ensure that messages to management are consistent to the fullest extent possible, supervisory conclusions or proposed actions should only be communicated to bank management, the bank board of directors, or other bank staff after such matters have been fully vetted within and between the federal banking agency and home-state banking department. The vetting process should, to the fullest extent possible, adhere to the exit meeting and examination report issuance time frames specified in the agreement. All parties should make every effort to expedite the process in order to deliver timely exam findings and efficient regulatory oversight.
12. When differences between the agencies arise on important matters, such as examination conclusions or proposed supervisory action, senior management from the home-state banking department and the appropriate federal banking agency should communicate to try to resolve the differences. In the event that the state and federal banking agency cannot reach agreement on important matters affecting the supervised institution, the respective agencies should coordinate the communication of those differences to the management or board of directors of the supervised institution, including the timing thereof and how the differing views will be presented. (See SR-99-17.)

Coordinating Activities with the Consumer Financial Protection Bureau

On May 16, 2012, the CFPB, the Federal Reserve Board, the FDIC, the NCUA, and the OCC entered into an MOU to facilitate the fulfillment of the agencies' responsibilities in a manner consistent with the provisions of sections 1022, 1024, and 1025 of the Dodd-Frank Act. The MOU covers depository institutions with more than $10 billion in total assets. The objectives of the MOU, among other things, are to establish which examination schedules must be coordinated, which examinations must be conducted simultaneously, what it means to conduct an examination simultaneously, and how insured depository institutions may request to opt out of simultaneous examinations.[31]

COORDINATION OF SUPERVISORY ACTIVITIES: COORDINATION ACTIVITIES AMONG THE RESERVE BANKS

Many large banks have interstate operations; therefore, close cooperation with the other federal and state banking agencies is critical. To facilitate coordination between the Federal Reserve and other regulators, District Reserve Banks have been assigned roles and responsibilities that reflect their status as either the

31. For more information, see the Board's June 4, 2012, press release at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20120604a.htm.

responsible Reserve Bank (RRB) with the central point of contact or the local Reserve Bank (LRB).

The RRB is accountable for all aspects of the supervision of a fully consolidated banking organization, which includes the supervision of all the institution's subsidiaries and affiliates (domestic, foreign, and Edge corporations) for which the Federal Reserve has supervisory oversight responsibility. The RRB is generally expected to work with LRBs in conducting examinations and other supervisory activities, particularly where significant banking operations are conducted in a local District. Thus, for SMBs, the LRB has an important role in the supervision of that subsidiary. However, the RRB retains authority and accountability for the results of all examinations and reviews that an LRB may perform on its behalf. See SR-05-27/CA-05-11, "Responsible Reserve Bank and Inter-District Coordination."

Responsible Reserve Bank

In general, the RRB for a banking institution has been the Reserve Bank in the District where the banking operations of the organization are principally conducted. For domestic banking institutions, the RRB typically will be the Reserve Bank District where the head office of the top-tier institution is located and where its overall strategic direction is established and overseen. For foreign banking institutions, the RRB typically will be the Reserve Bank District where the Federal Reserve has the most direct involvement in the day-to-day supervision of the U.S. banking operations of the institution.

When necessary, the Board's Division of Supervision and Regulation (S&R), in consultation with DCCA, may designate an RRB when the general principles set forth above could impede the ability of the Federal Reserve to perform its functions under law, do not result in an efficient allocation of supervisory resources, or are otherwise not appropriate.

Duties of RRBs

The RRB develops the consolidated supervisory plan and ensures that the scope and timing of planned activities conducted by participating Districts and agencies pursuant to the plan are appropriate. The RRB designates the central point of contact or lead examiner and ensures that all safety-and-soundness, information technology, trust, consumer compliance, Community Reinvestment Act (CRA), and other specialty examinations, inspections, and visitations are conducted and appropriately coordinated within the System and with other regulators. In addition, the RRB manages all formal communications with the foreign and domestic supervised entity, including the communication of supervisory assessments, ratings, and remedial actions.[32]

Sharing of RRB Duties

To take advantage of opportunities to enhance supervisory effectiveness or efficiency, an RRB is encouraged to arrange for the LRB to undertake on its behalf certain examinations or other supervisory activities. For example, an LRB may have relationships with local representatives of the institution or local supervisors; leveraging these relationships may facilitate communication and reduce costs. Additionally, LRBs may provide specialty examination resources—in the case of CRA examinations, LRB staff often provide valuable insights into local communities and lending institutions that should be factored into the CRA assessment. When other Reserve Bank Districts conduct examinations and other supervisory activities for the RRB, substantial reliance should be placed on the conclusions and ratings recommended by the participating Reserve Bank(s).

The RRB retains authority and accountability for the results of all examinations and reviews performed on its behalf and, therefore, must work closely with LRB examination teams to ensure that examination scopes and conclusions are consistent with the supervisory approach and message applied across the consolidated organization. If an LRB identifies major issues in the course of directly conducting supervisory activities on behalf of an RRB, those issues should be brought to the attention of the RRB in a timely manner.

If an RRB arranges for an LRB to conduct supervisory activities on its behalf, the LRB is responsible for the costs of performing the activities. If the LRB is unable to fulfill the request from the RRB to perform the specified

32. See SR-96-33.

activities, the RRB should seek System assistance, if needed, by contacting Board staff or using other established procedures for coordinating resources.

In general, LRBs are responsible for the direct supervision of SMBs located in their district. LRBs and host states will not routinely examine branches of SMBs or issue separate ratings and reports of examination. Similar to the relationship between the RRBs and LRBs, home-state supervisors[33] will coordinate the activities of all state banking departments and will be the state's principal source of contact with federal banking agencies and with the bank itself. Also, host states will not unilaterally examine branches of interstate banks. Close coordination among the Reserve Banks and other appropriate regulators for each organization is critical to ensure a consistent, risk-focused approach to supervision.

COMMUNICATION OF SUPERVISORY FINDINGS

This subsection on the "Communication of Supervisory Findings" is based on the guidance in SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings," which applies to all Federal Reserve-supervised banking organizations. In a supervisory finding, examiners should convey, if evident, both the root cause of the finding and the potential effect of the finding on the organization. Examiners should also consider the guidance in 12 CFR 262, Appendix A, "Statement Clarifying the Role of Supervisory Guidance," for more information on the communication of supervisory findings, including the appropriate identification of unsafe or unsound practices or other deficiencies in risk management, including compliance risk management, or other areas that do not constitute violations of law or regulation.

Communication of supervisory findings to the organization's board of directors is an important part of the supervision of a banking organization. While the board itself may not directly undertake the work to remediate supervisory findings as senior management is responsible for the organization's day-to-day operations, it is nevertheless important that the board be made aware of significant supervisory issues and ultimately be accountable for the safety and soundness and assurance of compliance with applicable laws and regulations of the organization.

Depending upon the size and complexity of the organization, supervisory findings are communicated in writing through formal examination or inspection reports, reports summarizing the results of targeted reviews, a roll-up of those reviews into a comprehensive report, any other supervisory communication, or some combination thereof. These written communications (referred to collectively as "reports" in this section) are generally directed to the board of directors, or an executive-level committee of the board[34] as appropriate. In turn, the board of directors (or executive-level committee of the board) typically will direct the organization's management to take corrective action and will provide management with appropriate oversight, including approvals of proposed management actions as necessary.

To be effective, the communication of supervisory findings must be (1) written in clear and concise language, (2) prioritized based upon degree of importance, and (3) focused on any significant matters that require attention.

Reserve Banks must formally communicate Matters Requiring Immediate Attention (MRIAs) and Matters Requiring Attention (MRAs) resulting from any supervisory activity to the organization in these written reports. In order to promote an understanding of these terms, examiners should include definitions of MRIAs and MRAs in all supervisory documents communicating supervisory findings.[35] When included in a safety-and-soundness examination or inspection report, MRIAs and MRAs should be listed in the "Matters Requiring Attention" section. In the case of findings from consumer compliance examinations, MRIAs and MRAs should be reflected in the "Executive Summary and Examination Ratings" section of the consumer

33. The State/Federal Supervisory Protocol and Agreement established definitions for home- and host-states. The home-state supervisor is defined as the state that issued the charter. It will act on behalf of itself and all host-state supervisors (states into which the bank branches) and will be the single state contact for a particular institution.

34. An executive-level committee of the board (such as, the audit committee or risk committee) typically meets regularly, keeps minutes of those meetings, and is accountable to and routinely reports to the board of directors.

35. In a safety-and-soundness report, these definitions could be included on the "Scope" page, in an appendix, or as a footnote on the "Matters Requiring Attention" section. In a consumer compliance report, these definitions could be included on the "Executive Summary and Examination Ratings" section.

affairs report of examination. Only outstanding MRIAs and MRAs are required to be discussed in the report; however, examiners have discretion to discuss closed MRIAs and MRAs in the report if such discussion would be meaningful.

For large banking organizations, an annual roll-up report summarizes the significant findings, based on outstanding MRIAs or MRAs, included in the reports of targeted reviews or other supervisory activities conducted during the supervisory cycle. These findings may be grouped by major supervisory issues, rating components, risks, or themes. This information should enable the banking organization's board of directors and any executive-level committee of the board to understand the substance and status of outstanding MRIAs or MRAs and focus their attention on the most critical and time-sensitive issues.

Communications to banking organizations concerning safety-and-soundness or consumer compliance MRIAs or MRAs must specify a timeframe within which the banking organization must complete the corrective actions. In certain circumstances, examiners may require the banking organization to submit an action plan that identifies remedial actions to be completed within specified timeframes. Action plans with intermediate- and long-term timeframes that span more than one supervisory or examination cycle with regard to safety-and-soundness matters, or a 12-month period with regard to consumer compliance issues, should include interim progress targets. Both safety-and-soundness and consumer protection or compliance considerations will remain a priority in determining whether the organization's timeframes to correct the matter are reasonable.

Matters Requiring Immediate Attention

MRIAs arising from an examination, inspection, or any other supervisory activity are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include (1) matters that have the potential to pose significant risk to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization; and (4) in the case of consumer compliance examinations, matters that have the potential to cause significant consumer harm. An MRIA will remain an open issue until resolution and examiners confirm the banking organization's corrective actions.

Required language. Federal Reserve examiners are expected to use the following standardized language to communicate MRIAs to the board of directors (or executive-level committee of the board):

"The board of directors (or executive-level committee of the board), or banking organization *is required to immediately...*"

Timeframe. The expected timeframe for a banking organization to address MRIAs is generally short, and may be "immediate," in the case of heightened safety-and-soundness or consumer compliance risk. For MRIAs that are necessary to preserve or restore the viability of a banking organization, the timeframe should take into account any potential losses to the FDIC's Deposit Insurance Fund, including the possibility that a delay in action will increase the potential for loss or the cost of resolution.

Organization response. Following its review of MRIAs discussed in the report, the banking organization's board of directors is required to respond to the Reserve Bank in writing regarding corrective action taken or planned along with a commitment to corresponding timeframes.

Supervisory follow-up. The Reserve Bank must follow up on MRIAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe specified for the action being required, and should be appropriate for the severity of the matter requiring the corrective action. The means of follow-up may vary depending upon the nature and severity of the matter requiring the action. Follow-up may take the form of a subsequent examination, a targeted review, or any other supervisory activity deemed suitable for evaluating the issue at hand.

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In such cases, examiners should consult with enforcement staff.[36] In all instances, examiners are expected to exercise judgment as to the supervisory activities best suited for evaluating a particular issue. Once follow-up is completed, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners are also expected to communicate in writing the results of their work and findings to the banking organization.

Matters Requiring Attention

MRAs constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time but when the timing need not be "immediate." While issues giving rise to MRAs must be addressed to ensure the banking organization operates in a safe-and-sound and compliant manner, the threat to safety and soundness is less immediate than with issues giving rise to MRIAs. Likewise, consumer compliance concerns that require less immediate resolution should be communicated as an MRA. An MRA typically will remain an open issue until resolution and confirmation by examiners that the banking organization has taken corrective action. If a banking organization does not adequately address an MRA in a timely manner, examiners may elevate an MRA to an MRIA. Similarly, a change in circumstances, environment, or strategy can also lead to an MRA becoming an MRIA. The key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action as well as the immediacy with which the banking organization must begin and complete corrective actions.

Required language. Federal Reserve examiners are expected to use the following standardized language to communicate MRAs to the board of directors (or executive-level committee of the board):

"The board of directors (or executive-level committee of the board), or banking organization *is required to...*"

36. Such consultation should be made in accordance with existing guidance to Reserve Bank supervisory staff on the processing of enforcement actions, which provides that recommendations concerning formal enforcement actions should be submitted to the Board's Legal Division.

Timeframe. Communications to banking organizations about MRAs must specify a timeframe within which the corrective action is expected to be completed. The timeframe, at least initially, may require estimation because the banking organization may first need to complete preliminary planning to establish the timeframe for initiating and completing the corrective action. The timeframes for MRAs are likely to become more precise over time as planning evolves and circumstances make the completion of the MRAs more urgent. Timeframes that span more than one examination cycle for safety-and-soundness issues or that exceed 12 months for consumer compliance issues should include appropriate interim progress reports.

Organization response. Following its review of the report, the banking organization's board of directors is required to provide a written response to the Reserve Bank regarding its plan, progress, and resolution of the MRA.

Supervisory follow-up. The Reserve Bank must follow-up on MRAs to assess progress and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed. For intermediate- or long-term corrective actions for MRAs, Reserve Bank follow-up may consist of assessing the organization's progress to address the MRAs, whether satisfactory or unsatisfactory, and noting whether the initial estimated timeframe continues to be reasonable or warrants adjustment.

The means of supervisory follow-up may vary based upon the nature and severity of the matter for which corrective action is expected. Follow-up may take the form of a subsequent examination, targeted review, continuous monitoring, reliance on validation work conducted by internal audit function, reliance on the results of examinations conducted by other supervisors, or any other supervisory activity deemed suitable for evaluating the issue at hand.[37]

37. Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective, as discussed in SR-13-1/CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing." (See this manual's section entitled "Internal Control and Audit Function, Oversight, and Outsourcing.") When relying on internal audit to follow up on MRAs, examiners are expected to review the relevant work papers and, when necessary, meet with internal audit staff who documented the resolution of the issue.

In some cases, when follow-up indicates the organization's corrective action has not been satisfactory, the initiation of additional formal or informal investigation or enforcement action may be necessary. In all instances, examiners are expected to exercise judgment regarding the supervisory activities best suited for evaluating a particular issue. Once follow-up is complete, examiners are expected to clearly and fully document the rationale for their decision to close any issue. Examiners also are expected to communicate in writing the results of their work and findings to the organization.

Supervisory Considerations

The volume of MRIAs and MRAs should be one of the many considerations in assigning a supervisory rating to a banking organization. The presence of a large number of MRIAs or MRAs may indicate that additional formal or informal investigation may be necessary or that the initiation of a formal or informal enforcement action may be warranted.

Irrespective of the number of MRIAs or MRAs, in some cases, additional formal or informal investigation may be necessary or the initiation of a formal or informal enforcement action may be warranted based on the severity of the issues, the repeat nature of issues, lack of responsiveness of management, violations of law, insider abuse, fraud, or other material deficiency. In any of these cases, examiners should consult with the Board's enforcement staff.

Factors in Escalating Issues into Enforcement Actions

The volume of open MRIAs and MRAs and the materiality of the issues therein to the safety and soundness of the banking organization are important overarching considerations in determining whether examiners need to consult with the Board's enforcement staff in escalating issues into enforcement actions.[38] In addition to the guidance presented in SR-13-13/CA-13-10, examiners should consider the following key factors in determining whether to recommend additional formal or informal investigation or enforcement action:

- the organization's supervisory ratings and financial condition;[39]
- whether the issues involve unsafe or unsound practices, violations of laws, noncompliance with regulations, insider abuse, fraud, or other material deficiencies;[40]
- the severity or repetitive or intentional nature of the issues;
- management's willingness and ability to correct the issues;
- management's history of instituting timely remedial or corrective actions;
- whether management already initiated corrective action or established procedures to prevent future deficiencies;
- whether criminal or other regulatory authorities are taking a formal enforcement or prosecutorial action against the same institution;
- the organization's history of violations of laws, noncompliance with regulations and unsafe and unsound unsatisfactory practices; and
- any other circumstances that warrant use of an enforcement action.

As described in this manual's section, "Formal and Informal Supervisory Actions," it is important for examiners and supervision staff to provide adequate support for all recommendations for both formal and informal actions in the examination report and associated workpapers.

Revising Supervisory Ratings

Supervisory ratings should be revised whenever there is strong evidence of significant changes to the bank's financial or operational condition.[41] It is important that supervisory ratings reflect a current assessment of an institution's financial condition and risk profile, as the ratings can affect risk-based deposit insurance premiums, statutory and regulatory requirements, including applications and the prompt corrective action provisions of the FDI Act, and supervisory

38. Issues are considered closed if the banking organization implements and examiners verify and validate the effectiveness of the corrective action, or if the organization's practices are no longer a concern because of a change in the organization's circumstances.

39. See SR-96-38, "Uniform Financial Institutions Rating System."

40. See 12 U.S.C. 1818(b)(1).

41. See SR-99-17, "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System."

reporting and examination requirements as well as other factors. While supervisory ratings are most frequently revised as a result of on-site supervisory activities, other sources of information reviewed off-site may also indicate the need for a rating change.[42]

In addition, when a component of one of the supervisory rating systems is changed, the Reserve Bank must also reaffirm or revise the other component ratings and the composite rating, based upon available information at that time. The factors contributing to a change in the rating of a selected component can affect one or more of the other components in the rating system as well as the composite rating. Accordingly, if there is a compelling reason to change a selected component rating, all of the other components in the supervisory rating system must be either reaffirmed or revised. As applicable for holding companies and SMBs, the risk management rating must also be reaffirmed or revised when a CAMELS or holding company rating is changed.

Any change to a component or composite rating and the rationale for that change must be communicated in writing via a letter or report to the board of directors of the affected institution (or to the senior U.S. management official in the case of a U.S. branch, agency, office, or nonbank subsidiary of a foreign bank) and to the appropriate state and federal supervisory agencies. When ratings are revised between scheduled Federal Reserve examinations and inspections, the revised rating should be entered into the appropriate Federal Reserve system of record.

REPORTS OF EXAMINATION

As mentioned above, depending upon the size and complexity of the organization, supervisory findings are communicated in writing in a number of ways. In general, a community bank receives a comprehensive report based on the findings from its statutorily mandated examination every 12 or 18 months. Historically, the agencies promoted consistency in the communication of examination findings by mandating certain pages in the report of examination. In 2019, the FFIEC members agreed on a set of principles that should apply to the completion of all reports of examination. The FFIEC members determined that a principles-based approach for completing the report of examination would better achieve the objectives of promoting consistency and communication amongst the agencies, while allowing individual supervisors the flexibility to document their assessment of financial institutions of different sizes, activities, risk profiles, and financial and managerial condition. See SR-19-6, “Federal Financial Institutions Examination Council Policy Statement on the Principles for Completing the Report of Examination,” for more information. For more information on the structure of the report of examination and timing expectation for completing reports of examination, see this manual’s section entitled, “Community Bank Supervision Process.”

Larger SMBs with greater than $10 billion in assets are generally examined as part of the continuous monitoring and inspection activities of the parent bank holding company. While the Federal Reserve is required to conduct a full-scope, on-site examination of these larger SMB at least once during each 12-month period, the scale and frequency of monitoring activities that inform this rating differs by institution. As such, the format of supervisory letters or examination reports for larger banks varies depending on the scope and subject matter examiners review. For larger SMBs, the Federal Reserve typically delivers the results of the annual SMB full-scope examination and CAMELS rating in the same letter as the bank holding company annual assessment.

Combined Reports

Reserve Banks may issue a combined report for a bank holding company and its lead SMB subsidiary when (1) a bank holding company’s lead bank subsidiary is an SMB and (2) the holding company’s board formally approves the release of a combined report to its lead SMB subsidiary. In cases where the company has more than one SMB, separate examination reports should be prepared for all other SMB subsidiaries. The Reserve Bank should send a letter to a qualified holding company that ex-

42. For example, significant change in financial condition may be evident from some combination of reports of examination conducted by other agencies, meetings or other communication with management of the institution, published financial reports or press releases, status reports submitted by the institution as required by an enforcement action, and information generated by ongoing surveillance activities.

plains its option of receiving a combined report. If the holding company's board wishes to receive a combined report, it should formally approve the release of the combined report to its lead SMB subsidiary by board resolution. (See SR-94-46, "Combined Examination/Inspection Report For Bank Holding Companies With Lead State Member Banks," and its attachment.)

Timing Standards for Completing Reports

Specific expectations for examination staff to complete the examination report vary depending on factors such as the size of the bank, the condition of the bank, and the level of supervisory coordination for a particular examination. In general, examination staff are expected to complete reports more promptly for SMBs that are poorly rated than SMBs that are in satisfactory condition. The manual sections discussing the supervisory programs of the various portfolios provide more detailed information on timing expectations for completing and sending examination reports to supervised institutions.

ENFORCEMENT ACTIONS

Generally, formal or informal enforcement actions are taken after the completion of an on-site bank examination. These examinations include commercial, trust, electronic data-processing, consumer, or other types of examinations. Formal or informal enforcement actions may also be taken when a Reserve Bank becomes aware of a problem at a bank that warrants immediate attention and correction.

When a bank's deficiencies are severe, uncorrected, repeat, or unsafe or unsound, or negatively affect the bank's condition, the Board may issue a formal action to correct practices. The Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease-and-desist, removal, prohibition, and civil money penalty assessments.

Informal supervisory actions are used when circumstances warrant a less severe form of action than the formal supervisory actions described above. Informal actions are not enforceable and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available. These informal actions include commitments, Board resolutions, and MOUs. For more information, see this manual's section entitled, "Formal and Informal Supervisory Actions."

APPEALS PROCESS

In general, questions about or objections to supervisory determinations made during the course of an inspection or examination are most effectively handled through the longstanding Federal Reserve practice of resolving any problems informally during the course of the inspection or examination process. If problems cannot be resolved through the inspection or examination process, the Board has developed guidelines that implement the intra-agency appeals process required by section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994. One of the key aspects of the appeals process developed under section 309 is the establishment of the Ombuds who

1. acts as a liaison between the agency and any affected person with respect to any problem such party may have in dealing with the agency resulting from the regulatory activities of the agency; and
2. ensures that safeguards exist to encourage complainants to come forward and preserve confidentiality

In March 2020, the Board revised its internal appeals process for institutions wishing to appeal an adverse material supervisory determination and its policy regarding the Ombuds for the Federal Reserve System. See 85 *Federal Register* 15,175 (March 17, 2020) and SR-20-28/CA-20-14, "Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System," for more information on the appeals process and the Ombuds Policy Statement.

INTRODUCTION

Community banks constitute the largest number of state member banks (SMBs) supervised by the Federal Reserve System. For community banks, the primary purpose of prudential regulation is to ensure the safety and soundness of each individual institution, thereby protecting the deposit insurance fund. The Federal Reserve scales or risk-focuses its supervisory expectations based on the size, risk profile, condition, and complexity of a bank and its activities.

DEFINITION OF A COMMUNITY BANKING ORGANIZATION

For supervisory purposes, the Federal Reserve uses the term "community bank" to generally describe a bank with less than $10 billion in total consolidated assets and "community banking organization" generally to describe an SMB or holding company with less than $10 billion in total consolidated assets.

RISK-FOCUSED SUPERVISION OF COMMUNITY BANKS

The risk-focused methodology for the supervision program for community banks reflects a continuous and dynamic process. The objective of a risk-focused examination is to effectively evaluate the safety and soundness of the bank, including the assessment of its risk management systems, financial condition, and compliance with applicable laws and regulations. In addition, the risk-focused supervision process of community banks aims to align resource requirements for examinations with the risks inherent in the bank's activities. Examiner judgment is another key element in effectively determining the initial scope of state member bank examinations.

The Federal Reserve has developed technological tools for examiners to improve the efficiency of both off-site and on-site supervisory activities. The goal of these measures is to facilitate greater consistency and more efficient, effective, and risk-focused examinations by better enabling staff to tailor the scope of examinations to the activities and risks of individual banks. The automation of various parts of the community bank examination process save examiners and bankers time, as a bank can submit requested pre-examination information electronically. Through these efforts, the Federal Reserve aims to strike an appropriate balance between off-site and on-site supervisory activities to ensure that community banks are subject to supervision that is both high-quality and resource-efficient.

The risk-focused methodology consists of several steps, each of which uses certain written products to facilitate communication and coordination.

Steps	***Products***
Understanding the bank	Institutional Overview
Assessing the bank's risk	Risk tiering or preliminary risk assessment
Defining examination activities	Scope memorandum Entry letter
Performing examination procedures	Risk-focused examination procedures from the Examination Documentation (ED) modules
Reporting the findings	Report of examination

Understanding the Bank

Institutional Overview

The risk-focused supervision process for community banks involves an assessment of the bank that enables examiners to tailor their examination to the bank's risk profile. In addition to examination reports and correspondence files, surveillance reports identify outliers when a bank is compared to its peer group. Review of this information helps examiners identify a bank's strengths and vulnerabilities, and is the foundation for determining the examination activities to be conducted.

The institutional overview should contain a concise executive summary that demonstrates an understanding of the institution's present condition and its current and prospective risk profiles as well as highlights key issues and past supervisory findings. General types of information that may be valuable to present in the overview include

- a brief description of the organizational structure;
- a summary of the organization's business strategies as well as changes in key business lines, growth areas, new products, etc., since the prior review;
- an overview of the board of directors, management, and corporate governance;
- a brief analysis of the consolidated financial condition and trends;
- descriptions of internal and external audit;
- risk assessment matrix;
- overview of risk management including key risk types (credit, market, liquidity, operational, legal, and compliance);
- key issues for the organization, either from external or internal factors;
- a description of the future prospects of the organization;
- a summary of supervisory activity performed since the last review;
- considerations for conducting future examinations; and
- the ability to conduct loan review off-site.

Assessing the Institution's Risks: Risk Tiering, Scoping, and Preliminary Risk Assessment

A bank's business activities present various combinations and concentrations of the noted risks depending on the nature and scope of the particular activity. Therefore, when assessing the bank's risks, consideration must be given to the institution's overall risk environment, the reliability of its internal risk management, the adequacy of its information technology systems, and the risks associated with each of its significant business activities.

The Federal Reserve uses financial metrics to help differentiate the level of risk between banks before examinations.[1] This helps examiners tailor examination expectations and procedures, which are discussed in the scope memorandum. For community SMBs, the scope of an examination work program for a particular risk dimension depends on a bank's risk classification, as follows:

- *High risk.* High risk means that under unfavorable market conditions, the bank's activities for a particular risk dimension often lead to adverse outcomes. Examiners apply the full extent of examination procedures and conduct additional work, as necessary, including independent verification and transaction testing, to reach, support, and document conclusions regarding the level of an SMB's risk exposure and the adequacy of management's efforts to mitigate and manage risk.[2]
- *Moderate risk.* Moderate risk means that in unfavorable markets, the bank's activities for a particular risk dimension occasionally result in adverse outcomes. Examiners apply a subset of examination procedures, with a focus on evaluating an SMB's key risk drivers and financial reports in order to confirm that risk is moderate. Independent examiner verification and transaction testing are applied to specific areas but reduced relative to high-risk areas.
- *Low risk.* Low risk means the expected incidence of adverse outcomes for a particular risk dimension is low, irrespective of market conditions. Examiners apply a smaller subset of examination procedures for low-risk areas than for moderate-risk areas, with a focus on evaluating an SMB's key risk drivers and financial reports in order to confirm that risk is low. Independent examiner assessment of risk management is reduced relative to moderate-risk cases.

Supervisory teams design the risk-aligned work programs for each risk dimension, resulting in procedural templates for general use in the examination process. For a given risk dimension, the degree of differentiation between low-, moderate-, and high-risk work programs directly depends, in part, on the predictive capacity of the risk dimension's surveillance metrics, as confirmed via back testing.

At each examination, the examiner-in-charge (EIC) confirms the risk classifications upon which planned work programs were based and, if needed, adjusts or expands the work pro-

1. See this manual's section entitled, "Federal Reserve System Bank Surveillance Program," for more information, and SR-19-9, "Bank Exams Tailored for Risk (BETR)."

2. The procedures that examiners perform for each examination area should focus on developing appropriate documentation to assess management's ability to identify, measure, monitor, and control risk.

grams. If initial discussions with management or additional information obtained during the examination indicate significant weaknesses in an SMB's risk management or higher than anticipated risk, examiners are expected to alter an examination's scope and associated work programs and appropriately document the modifications in examination work papers.

All work programs should continue to include the review and verification of corrective action taken to address any outstanding Matters Requiring Immediate Attention (MRIA) or Matters Requiring Attention (MRA).

DEFINING EXAMINATION ACTIVITIES

Scheduling the Examination

Contact with the bank is encouraged to improve the examiners' understanding of the institution and the market in which it operates. A pre-examination interview or visit should generally be conducted as a part of each full-scope examination. This meeting gives examiners the opportunity to determine whether there have been any changes in bank management and changes to the bank's policies, strategic direction, management information systems, and other activities. During this meeting, particular emphasis should be placed on learning about the bank's new products or new markets it may have entered. The pre-examination interview or visit also provides examiners with (1) management's view of local economic conditions, (2) an understanding of the bank's regulatory compliance practices, and (3) its management information systems and internal and/or external audit function. In addition, Reserve Banks should contact the state banking supervisor to determine whether it has any special areas of concern where the examiners should focus.

In addition to obtaining an understanding of the institution, Reserve Bank examination staff contacts community bank management prior to an on-site examination in order to provide bank management adequate time to plan for the examination and address logistical issues for the on-site examination team. The EIC, or a designee, should contact bank management 8 to 12 weeks prior to the start date of the examination in order to communicate the proposed examination start and close dates and ensure that bank management and key bank staff are available during the proposed dates. Contacting the bank with the appropriate lead time allows examiners and bank management to reschedule certain supervisory activities if there are conflicts with previously scheduled regulatory, audit, or loan reviews. At that time, bank management may also request that examiners review loan files off-site and make the necessary arrangements for Reserve Bank staff to obtain the technical information necessary to confirm that the bank can support an off-site review. See SR-16-8, "Off-site Review of Loan Files."

Scope Memorandum

As an integral product in the Federal Reserve's risk-focused methodology, the scope memorandum identifies the central objectives of the examination. The memorandum also ensures that the examination strategy is communicated to appropriate examination staff, which is of key importance, as the scope will likely vary from examination to examination. Examination procedures are tailored to the characteristics of each bank, keeping in mind its size, complexity, and risk profile. Procedures should be completed to the degree necessary to determine whether the bank's management understands and adequately controls the levels and types of risk that are assumed. In addition, the scope memorandum should address the general banking environment, economic conditions, and any changes foreseen by bank management that could affect the bank's condition. Some of the key factors that should be addressed in the scope memorandum are described below.

- *Summary of Pre-Examination Meeting.* The results of the pre-examination meeting, which is discussed above, should be summarized. Examiners should appropriately describe meeting results that affect examination coverage. For more information, see SR-19-5, "Communication Expectations for Community Bank Examinations and Inspections."
- *Summary of Risk Categories and Corresponding Examination Procedures.* The scope memorandum should include a preliminary assessment of the bank's condition and major risk areas that will be evaluated through the examination process. This assessment is largely driven through the risk-tiering and scoping

process described above. The scope memorandum should specifically detail the risk category (high, moderate, or low) of each risk type, and provide a description of the expected examination procedures to complete for that area. In addition, any supplemental and reference modules used should be discussed.

- *Summary of Audit and Internal Control Environment.* A summary of the scope and adequacy of the audit environment should be prepared, which may result in a modification of the examination procedures initially expected to be performed. Activities that receive sufficient coverage by the bank's audit system can be tested through the examination process. Certain examination procedures could be eliminated if a bank's audit and internal control areas are deemed satisfactory.
- *Summary of Loan Review.* On the basis of the preliminary risk assessment, the anticipated loan coverage should be detailed in the scope memorandum. In addition to stating the percentage of commercial and commercial real estate loans to be reviewed, the scope memorandum should identify which specialty loan reference modules of the general loan module are to be completed. The memorandum should specify activities within the general loan module to be reviewed as well as the depth of any specialty reviews.
- *Job Staffing.* The staffing for the examination should be detailed. Particular emphasis should be placed on ensuring that appropriate personnel are assigned to the high-risk areas identified in the bank's risk assessment. The institution's organizational structure and complexity are significant considerations when planning the specific supervisory activities to be conducted. In addition, the scope memo should discuss the examination activities that are expected to be performed on-site at the bank as well as the supervision activities that will be performed off-site.

Banks may need additional time to prepare for an examination, particularly for allocating appropriate bank staff to support heavily reviewed areas. Once the scope memo is finalized, Federal Reserve staff should provide bank management with the contact information of key examination personnel. More specifically, the EIC should provide to bank management a verbal overview of the preliminary scope of review and the size and composition of the examination team, including names, roles and responsibilities, workspace needs, and whether staff members will be working on-site or off-site. The EIC also should inform bank management of the approximate number of trainees that will participate in the on-site examination. The EIC should communicate to bank management any subsequent material changes to the scope of review.

Entry Letter

The entry letter or first day letter identifies the information necessary for the successful execution of the examination procedures. The entry letter should be tailored to fit the specific character and profile of the institution to be examined and the scope of the activities to be performed. Thus, effective use of entry letters depends on the planning and scoping of a risk-focused examination. To eliminate duplication and minimize the regulatory burden on an institution, entry letters should not request information that is readily available to Federal Reserve Bank staff. When needed, the entry letter should include requests for information on specialty activities. The specific items selected for inclusion in the entry letter should meet the following guidelines:

- reflect risk-focused supervision objectives and the examination scope
- facilitate efficiency in the examination process and lessen the burden on financial institutions
- limit, to the extent possible, requests for special management reports
- eliminate items used for audit-type procedures (for example, verifications)
- distinguish between information to be sent to the EIC for off-site examination procedures and information to be held at the institution for on-site procedures
- allow management sufficient lead time to prepare the requested information

To allow bank management sufficient time to gather all requested information, examiners should transmit a first day letter to the bank four to eight weeks prior to the examination start date. In addition, when submitting the first day letter, examiners should specify the as-of date for the data requested and note if updated data should be made available on-site. Examiners also should provide contact information for questions regarding the request list and for technical assistance regarding data transmissions.

Performing Examination Procedures

Overview of Examination Documentation (ED) modules. Interagency ED modules form the basis of the examination procedures to be completed during examinations of state member community and regional banks.[3] The ED modules have been developed and designed to define common objectives for the review of important activities within institutions and to assist in the documentation of examination work. The modules are categorized as primary, supplemental, or reference modules. The primary modules contain procedures to assess capital adequacy, asset quality, management and board oversight, earnings, liquidity, and sensitivity to market risk. The supplemental and reference modules address other subject areas, including procedures for conducting a thorough review of a bank's loan and investment portfolio, a comprehensive assessment of funds-management practices, the adequacy of internal controls, the accuracy of regulatory reporting, other assets and other liabilities and asset and wealth management.

The modules establish a three-tiered approach for the review of a bank's activities: The first tier is the core analysis, the second tier is the expanded review, and the final tier is the impact analysis. The core analysis includes a number of decision factors to be considered collectively, as well as individually, when evaluating the potential risk to the bank. To help the examiner determine whether risks are adequately managed, the core analysis section contains a list of procedures that may be considered for completion. When significant deficiencies or weaknesses are noted in the core analysis review, the examiner may reference the expanded and impact analysis for those decision factors that present the greatest degree of risk for the bank.

Use of ED modules. The use of the modules are tailored to the characteristics of each bank based on its size, complexity, and risk profile. As a result, the extent to which each module should be completed will vary from bank to bank. Federal Reserve examiners complete certain ED module procedures based on the bank's risk category for a particular risk type. The risk-tiering process, which is described above, utilizes both qualitative and financial metrics to identify banks that should be subjected to a higher level of examination testing. Much of this information is gathered through the off-site surveillance process. See the manual section entitled, "Federal Reserve System Bank Surveillance Program," for more information.

The quantitative information obtained through the surveillance process is only one consideration, albeit an important one, in setting the examination scope and determining the appropriate procedures to apply at an individual bank. Qualitative considerations, including but not limited to, the nature of the risk, risk management practices, management responsiveness to prior examination findings, the number and significance of prior matters requiring immediate attention or matters requiring attention, also affect an examiner's scoping decision. Examiners should exercise appropriate supervisory judgment when including or excluding examination procedures to complete during an examination.

3. The Federal Reserve, the Federal Deposit Insurance Corporation, and representatives from the state banking agencies maintain and develop the ED modules.

REQUESTING ADDITIONAL INFORMATION AFTER THE START OF THE EXAMINATION

The EIC should have a process for requesting additional documentation from bank staff that avoids duplicative requests. Suggested methods include (1) requiring examiners to first review information already submitted prior to requesting new information, and (2) centralizing information requests through one designated examiner who must verify whether the information has already been provided.

REPORTING THE FINDINGS: REPORT OF EXAMINATION

Community Bank Report of Examination

The format of the community bank report of examination focuses on content rather than specific pages. The format allows examiners to use certain content headings, which follow a continuous-flow reporting format, and to use certain required report pages. The community bank examination report format may, however, continue to consist of specific or individual report pages, depending on the circumstances.

The community bank report of examination instructions distinguish between mandatory content (when the bank's condition or circumstances warrant) versus optional content. The examiner thus has discretion in the arrangement of certain content. For examinations (and inspections) of community banking organizations rated "4" or "5," examiners may use a letter-format report provided all mandatory and any applicable optional information is in the report.

Subject to certain limitations, the examiner may customize and streamline the community bank examination report to focus the examination's findings on matters of risk and importance to the bank's overall financial condition. The format for the community bank examination report and its instructions should strengthen communications with the bank's board of directors and senior management and minimize reporting burden. The report incorporates applicable specialty examination findings with the overall safety-and-soundness findings, thus culminating in a more comprehensive safety-and-soundness assessment.

The scope and depth of matters discussed under a content heading or on an examination report page, whether required or optional, will vary based on the issues and areas of concern presented as well as on their severity. A more abbreviated discussion may be warranted for community banks that are found to be in sound financial condition, with no material concerns or issues. All examination reports should contain sufficient documentation to support findings and supervisory conclusions.

Examiners completing the community bank examination report also should follow the guidance presented in the Interagency Policy Statement on the Report of Examination. Federal Financial Institutions Examination Council members developed a principles-based approach for completing the report of examination to achieve the objectives of promoting consistency and communication amongst the agencies, while allowing individual supervisors the flexibility to document their assessment of financial institutions of different sizes, activities, risk profiles, and financial and managerial conditions. See SR-19-6, "Interagency Policy Statement on the Report of Examination," for more information.

The instructions below list the content headings or report pages of the open and confidential sections of the community bank examination report. The sequence of applicable pages through the Management/Risk Management section are static. The remaining pages should generally follow the sequence of pages outlined in the template. The financial components (CAELS) may be arranged in order of importance and the corresponding ratios/tables associated with each financial component should be adjusted to illustrate the specific circumstances at the institution.

COMMUNITY BANK REPORT OF EXAMINATION INSTRUCTIONS

Open Section[4]

Content Heading or Report Page Title

Cover Page

A separate cover page is *mandatory*. The cover sheet should contain a statement that the contents of the report of examination contain confidential supervisory information.

Table of Contents

A separate table of contents page is *mandatory*. The table of contents indicates the pages included in the report. All mandatory pages are to be included in each examination report. Optional pages are added as necessary. The mandatory Signature of Directors page is the last page in the open section of the report. Additional supplemental pages may be added to the report at the examiner's discretion. Page numbers should be included for completeness.

Scope

The Scope content heading or report page is *mandatory*. This page may be a combined content heading or a separate report page. The scope should include the examiner's comments on

4. An illustrative template of the community bank report of examination is provided at the end of this manual section. The asterisk (*) next to a report page denotes an optional page that is mandatory if circumstances relevant to the page apply.

examination depth, scope, and procedures performed for each area of review, including any specialty areas. The examination's scope should generally address the following:

- the date of examination (commencement and conclusion)
- the type of examination (full-scope, targeted, joint, concurrent, combined (bank and bank holding company))
- the agency or agencies conducting the community bank examination
- areas reviewed and analyzed (If the examination is targeted, the examiner should identify specific areas reviewed.)
- the percentage and type of loans reviewed, if any
- a confirmation that examination results were discussed with the organization, including a list of those who attended the meeting
- identification of the bank's peer group
- if necessary, recognition that the bank is operating under a formal or informal supervisory action (If so, state that the provisions of the action were reviewed and compliance was assessed.)

Summary of Examination Ratings

The Summary of Examination Ratings content heading or report page is *mandatory.* All supervisory ratings assigned during the examination and for the two previous examinations should be provided. The supervisory ratings should be followed by the uniform definition of the assigned composite rating. The uniform definitions of the component ratings assigned need not be included in reports; they should, however, be made available to the board of directors and management on request. Include any specialty or targeted examination ratings assigned or other assessments, including findings from other on-site supervisory events during the recent Federal Reserve examination cycle. In all cases, a concluding statement should be provided that reminds the directorate of its responsibility to review the entire report of examination. The report should instruct each director to sign the Signature of Directors page.

Examination Conclusions

The Examination Conclusions content heading or report page is *mandatory.* This section of the examination report informs the bank's board of directors of the most significant and most important supervisory issues or concerns identified during the examination as well as the examination's findings and general conclusions. This section should contain a footnote noting that any institution about which the Federal Reserve makes a written material supervisory determination is eligible to utilize the appeals process as described in the Appeals Process and Board Ombudsman (Ombuds) Policy Statement. For more information, see 85 Fed. Reg. 15,175 (March 17, 2020) as well as SR-20-28/CA-20-14, "Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System."

The board of directors and senior management of an institution that is rated a composite "4" or "5" are to be informed that the bank is a problem institution that warrants special supervisory attention.[5] The board of directors and senior management of banks that are rated composite "3" are to be informed that their condition is not satisfactory, that the bank may be subject to more-than-normal supervision, and that the cited supervisory issues and areas of concerns may cause their bank to be considered a problem institution if the weaknesses are not promptly and adequately addressed. This content heading or report page also should discuss significant weaknesses in 1- or 2-rated institutions, and a brief summary of the bank's condition should be provided.

This section should contain an overview of the bank's financial condition. In addition, this section should contain the examiner's most significant recommendations and management's plans for corrective action.

In terms of presenting the information, examiners should include references to additional supporting information elsewhere in the report. The most important comments should be described first. Comments should be provided primarily on areas of the bank's operations and aspects of its financial condition that display weaknesses, deficiencies, or vulnerabilities. While examiners may recognize positive actions taken by management, laudatory or conclusive

5. See the subsection below entitled "Community State Member Banks Rated Composite '4' or '5'," for more information on the use of a letter-format report for communicating the findings of on-site, safety-and-soundness examinations hat result in composite supervisory ratings of "4" or "5."

remarks and endorsements of specific management actions should be avoided.

Significant recommendations presented elsewhere in the report should be mentioned. Significant apparent violations should also be discussed briefly, but they should be presented in greater detail under the content heading or the report page for Apparent Violations of Laws and Regulations.

Apparent Violations of Laws and Regulations

The content heading or report page is optional.* However, when apparent violations of federal or state banking laws and regulations are found, it is *mandatory* that they be listed in detail on this page. Apparent violations of the Bank Secrecy Act should also be listed in detail on the Bank Secrecy Act and Anti-Money-Laundering Compliance report page.

The format for listing apparent violations should be consistent. A heading for each apparent violation listed should name the applicable statute and/or regulation and provide a brief description of what the law covers. This summary should be followed by a brief description of the requirements of the statute and/or regulation and a discussion of how or why the apparent violation occurred. The examiner should describe any plans or recommendations for correction. If a review of the Bank Secrecy Act is conducted separately, or as part of another examination, a statement of this fact should be included under the Bank Secrecy Act and Anti-Money-Laundering Compliance report page.

Matters Requiring Attention

The Matters Requiring Attention content heading or report page is *mandatory*. It is intended to complement the complete findings of the report of examination and is prepared for the use of the board of directors and the bank's management. The focus should be on identified problems, rather than on strengths of the organization. Problems should be presented succinctly and clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted.

Include a brief summary statement regarding the status of prior MRIAs and MRAs. A detailed assessment of each prior MRIA or MRA is not required. For example, verbiage in the section could state that all, most, or none of the required items were addressed. Comments in this section should provide a reference to any section of the report where issues that are repeated or incomplete are discussed, if applicable. Repeated matters requiring attention that were not considered previously addressed should be explained in this section.

The definitions of MRIAs and MRAs should be included as a footnote on this page. When issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners should not criticize an institution for a "violation" of supervisory guidance (as supervisory guidance is not legally binding). When appropriate, examiners may reference (including in writing) supervisory guidance (such as interagency statements, advisories, bulletins, and policy statements) to provide examples of safe-and-sound conduct, appropriate risk management practices, and other approaches to addressing compliance with laws or regulations.

Compliance with Enforcement Actions

The Compliance with Enforcement Actions content heading or report page is optional.* The heading or page is *mandatory,* however, if the institution is under a formal or informal supervisory action. An assessment that summarizes the institution's overall compliance with the supervisory action should be included in this section of the report. As appropriate, the examiner should describe the level of compliance for each provision; provide detailed analysis explaining how compliance was achieved; or detail what actions have been taken and what actions are necessary to achieve full compliance. A detailed assessment of provisions that have been in full compliance for more than one examination is not required.

Directorate Responsibility

The content heading or report page is *mandatory*. This section, which is located after the presentation of key examination findings, is to inform each member of the board that they are responsible for thoroughly reviewing the report of examination. Each director must sign the Signature of Directors page at the conclusion of this report.

Management/Risk Management

The content heading or report page is *mandatory.* A separate section is required. The reported information under this content heading should always include (1) the risk-management numerical rating; (2) the mandatory discussion of the risk factors—types of risk (discussion of operational risk, legal risk, and compliance risk should be included in this section of the report. Discussion of credit risk, market risk, and liquidity risk, should be included in the Analysis of Financial Factors section for the respective financial component); (3) the adequacy of risk management associated with risk levels and risk trends; and (4) the impact of specialty examination areas on relevant risk areas. The fourth item, for example, might consist of a discussion of the impact of any information technology concerns on operational and other relevant risks, what impact any findings on fiduciary activities have on legal or other risks, or compliance concerns. As applicable, examiners should communicate conclusions/findings of any evaluation of the adequacy of an institution's audit department/program as part of this section. Findings can be communicated as part of the overall Management comments, or as a standalone "Audit" subsection within the Management/Risk Management section.

Within this section of the report, management and the board of directors should be evaluated on how they operate the institution in a safe and sound manner and on their ability to identify, measure, monitor, and control the risks of the institution's activities. Examiners should give consideration to

1. the level, quality, and adequacy of supervisory oversight and support provided by the board of directors and senior management;
2. compliance with banking and other statutes, regulations, and supervisory agreements;
3. the ability to plan for and respond to risks that may arise from changing business conditions or the initiation of a new product or service;
4. the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems used to control risks throughout the bank;
5. the adequacy and level of compliance with the board of directors policies and procedures and the bank's other internal policies and controls that are necessary to operate the bank in a safe and sound manner;
6. the adequacy of internal accounting control systems, the bank's audits and audit function, and the bank's internal control systems (discuss all of these in detail);
7. the responsiveness to recommendations from auditors and supervisory authorities;
8. the reasonableness of compensation policies and avoidance of, or tendency toward, self-dealing;
9. the business strategy and policies and procedures for avoiding conflicts of interests;
10. a demonstrated understanding and willingness to serve the legitimate banking needs of the community;
11. the institution's management depth and succession;
12. the extent that management is affected by or is susceptible to dominant influence or concentration of authority; and
13. the overall risk profile and performance of the institution.

See SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion," and this manual's section on "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating," for specific guidance on rating the adequacy of risk-management processes and internal controls.

Examiners should provide the risk-management rating and discuss the risk factors and the adequacy of risk management associated with the risk levels and risk trends. In addition, examiners should discuss the impact of specialty areas on relevant risk areas. For example, examiners should discuss the impact of any information technology concerns on operational and other relevant risks as well as what impact any findings on fiduciary activities or compliance concerns have on legal and other risks. The section should discuss the management and risk-management analysis and "R" rating assignment for the bank holding company RFI/C(D) rating as well as the examiner's risk management conclusions about the bank holding company.

Risk Assessment Matrix

The inclusion of a risk assessment matrix is *mandatory* under the Management/Risk Management content heading, or the confidential section of the report of examination.

A risk matrix is used to identify significant activities, the type and level of inherent risks in these activities, and the adequacy of risk management over these activities as well as to determine composite risk assessments for each of these activities and the overall institution. A risk matrix can be developed for the consolidated organization, for a separate affiliate, or along functional business lines. The matrix is a flexible tool that documents the process followed to assess the overall risk of an institution and is a basis for preparation of the narrative risk assessment.

Activities and their significance can be identified by reviewing information from the institution, the Reserve Bank, or other supervisors. After the significant activities are identified, the type and level of risk inherent in them should be determined. Types of risk may be categorized as previously described or by using categories defined either by the institution or other supervisory agencies. If the institution uses risk categories that differ from those defined by the supervisory agencies, the examiner should determine if all relevant types of risk are appropriately captured. If risks are appropriately captured by the institution, the examiner should use the categories identified by the institution.

For the identified functions or activities, the inherent risk involved in that activity should be described as high, moderate, or low for each type of risk associated with that activity. The following definitions apply:

- *High inherent risk* exists where the activity is significant or positions are large in relation to the institution's resources or to its peer group, where there are a substantial number of transactions, or where the nature of the activity is inherently more complex than normal. Thus, the activity potentially could result in a significant and harmful loss to the organization.
- *Moderate inherent risk* exists where positions are average in relation to the institution's resources or to its peer group, where the volume of transactions is average, and where the activity is more typical or traditional. Thus, while the activity potentially could result in a loss to the organization, the loss could be absorbed by the organization in the normal course of business.
- *Low inherent risk* exists where the volume, size, or nature of the activity is such that even if the internal controls have weaknesses, the risk of loss is remote or, if a loss were to occur, it would have little negative impact on the institution's overall financial condition.

This risk assessment is made without considering management processes and controls. Those factors are considered when evaluating the adequacy of the institution's risk-management systems. When assessing the adequacy of an institution's risk management systems for identified functions or activities, the focus should be on findings related to the key elements of a sound risk management system: active board and senior management oversight; adequate policies, procedures, and limits; adequate risk management, monitoring, and management information systems; and comprehensive internal controls.

Taking these key elements into account, the examiner should assess the relative strength of the risk management processes and controls for each identified function or activity. Relative strength should be characterized as strong, acceptable, or weak as defined below:

- *Strong risk management* indicates that management effectively identifies and controls all major types of risk posed by the relevant activity or function. The board and management participate in managing risk and ensure that appropriate policies and limits exist, which the board understands, reviews, and approves. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide the necessary information and analysis to make timely and appropriate responses to changing conditions. Internal controls and audit procedures are appropriate to the size and activities of the institution. There are few exceptions to established policies and procedures, and none of these exceptions would likely lead to a significant loss to the organization.
- *Acceptable risk management* indicates that the institution's risk-management systems, although largely effective, may be lacking to some modest degree. It reflects an ability to cope successfully with existing and foresee-

able exposure that may arise in carrying out the institution's business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk-monitoring procedures, reports, and management information systems are considered effective in maintaining a safe and sound institution. Risks are generally being controlled in a manner that does not require more than normal supervisory attention.

- *Weak risk management* indicates risk management systems that are lacking in important ways and, therefore, are a cause for more than normal supervisory attention. The internal control system may be lacking in important respects, particularly as indicated by continued control exceptions or by the failure to adhere to written policies and procedures. The deficiencies associated in these systems could have adverse effects on the safety and soundness of the institution or could lead to a material misstatement of its financial statements if corrective actions are not taken.

The composite risk for each significant activity is determined by balancing the overall level of inherent risk of the activity with the overall strength of risk management systems for that activity. For example, commercial real estate loans usually will be determined to be inherently high risk. However, the probability and the magnitude of possible loss may be reduced by having very conservative underwriting standards, effective credit administration, strong internal loan review, and a good early warning system. Consequently, after accounting for these mitigating factors, the overall risk profile and level of supervisory concern associated with commercial real estate loans may be moderate. To facilitate consistency in the preparation of the risk matrix, general definitions of the composite level of risk for significant activities are provided as follows:

- A *high composite risk* generally would be assigned to an activity in which the risk management system does not significantly mitigate the high inherent risk of the activity. Thus, the activity could potentially result in a financial loss that would have a significant negative impact on the organization's overall condition, in some cases, even when the systems are considered strong. For an activity with moderate inherent risk, a risk management system that has significant weaknesses could result in a high composite risk assessment because management appears to have an insufficient understanding of the risk and uncertain capacity to anticipate and respond to changing conditions.
- A *moderate composite risk* generally would be assigned to an activity with moderate inherent risk, which the risk management systems appropriately mitigate. For an activity with low inherent risk, significant weaknesses in the risk management system may result in a moderate composite risk assessment. On the other hand, a strong risk management system may reduce the risks of an inherently high-risk activity so that any potential financial loss from the activity would have only a moderate negative impact on the financial condition of the organization.
- A *low composite risk* generally would be assigned to an activity that has low inherent risks. An activity with moderate inherent risk may be assessed a low composite risk when internal controls and risk management systems are strong, and when they effectively mitigate much of the risk.

While support comments for operational, legal, and compliance risks will be included in Risk Assessment Matrix section of the report of examination, supporting comments for credit, market, and liquidity risks, can be found under their respective components in the Analysis of Financial Factors section.

- *Operational Risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events (this definition is consistent with the Basel committee's definition of operational risk).
- *Compliance Risk* is the risk of regulatory sanctions, fines, penalties, or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal Risk* is the potential that actions against he institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

The following is an example of the Risk Assessment Matrix:

Risk Assessment Matrix

Type of risk	*Inherent risk*	*Adequacy of risk management*	*Composite risk*	*Trend*
Credit	Moderate	Weak	High	Increasing
Market	Low	Weak	Low	Stable
Liquidity	High	Strong	Moderate	Decreasing
Operational	Low	Acceptable	Low	Stable
Legal	Low	Acceptable	Low	Stable
Compliance	Low	Acceptable	Low	Stable

Analysis of Financial Factors

The content heading or report page is *mandatory.* It is to be included as a separate section and should include all analyses and conclusions for each financial component. Subheadings are to be used to depict the ratings and the analysis of the individual components and other topics of discussion. The order is optional. However, the more significant issues should be addressed at the beginning of this analysis. In addition to the CAELS components—Capital adequacy, Asset quality, Earnings, Liquidity, and Sensitivity to market risk—listed below, the bank holding company RFI/C(D) rating system component analysis should be reported in this section, if applicable. Financial tables and graphs are optional. They may also be included in an appendix.

1. *Capital adequacy.* Capital adequacy should be evaluated in relation to relevant regulations, the nature and extent of risks to the bank, and the ability of management to address and control these risks to the organization. Consideration is to be given to (1) the level of, quality of, and changes in capital and the bank's overall financial condition; (2) the nature, trend, and volume of problem assets and the adequacy of the allowance for loan losses, allowance for credit losses and other valuation reserves; (3) risk exposures, including those presented by off-balance-sheet activities; (4) the quality and strength of earnings; (5) the balance sheet's composition, including the nature and amount of intangible assets, market risk, concentration risk, and non-traditional-activity risk; (6) equity maintenance and any growth experiences, plans, and prospects; (7) the reasonableness of dividends; (8) the access to capital markets and other appropriate sources of financial assistance; and (9) the ability of management to address emerging needs for additional capital.
2. *Asset quality*. Asset quality should be evaluated in relation to (1) the level, distribution, severity, and trend of problem, classified, delinquent, nonaccrual, nonperforming, and restructured assets, both on- and off-balance-sheet; (2) the adequacy of the allowance for loan and lease losses, allowance for credit losses and other valuation reserves (including the adequacy of the bank's methodology and written documentation policies, procedures, and practices); (3) management's awareness of problem loans and their causes and its demonstrated ability to identify, administer, and collect problem assets; (4) the diversification and quality of loan and investment portfolios; (5) the adequacy of loan-administration and lending policies, procedures, and practices; (6) the adequacy of workout procedures for problem credits; (7) the quality of investment securities and the adequacy of investment policies, procedures, and practices; (8) the extent of securities underwriting activities and exposure to

counterparties in trading activities; (9) the credit risk that is arising from, or reduced by, off-balance-sheet transactions;[6] (10) asset concentrations (including those assets, problem credits, and other transfer-risk problems in particular economic sectors); (11) the volume and nature of documentation exceptions; (12) the effectiveness of credit administration procedures, underwriting standards, risk-identification practices, internal controls, internal loan-review and credit-grading systems (including noted significant differences between the internal loan grades and the examination's loan classifications), and management information systems; and (13) the adequacy of policies, procedures, and practices involving financial futures and foreign exchange trading.

3. *Earnings.* The quality and quantity of earnings should be evaluated in relation to (1) the ability to provide for adequate capital through retained earnings; (2) the level, quality (including the strength of net interest margin, the amount of noninterest income and expense, and the extent of reliance on unusual or nonrecurring gains or losses), and stability of earnings; (3) the level of, composition of, reasonableness of assumptions for, and the extent of management's control over any variances between actual results versus the budgeted projections of income and expenses in relation to the size and nature of the bank's operations; (4) the vulnerability of earnings to market-risk exposures; (5) the adequacy of provisions to the allowance for loan and lease losses, allowance for credit losses and other valuation reserves; (6) the impact of extraordinary items, securities transactions, and tax effects on net income; and (7) the adequacy of budgeting systems, forecasting processes (including the reasonableness of assumptions), and management information systems.
4. *Liquidity.*[7] Liquidity and asset-liability management should be evaluated in relation to (1) the trend and stability of deposits; (2) the degree of and reliance on short-term volatile sources of funds, including any undue reliance on borrowings or brokered deposits to fund longer-term assets; (3) the availability of assets that are readily convertible to cash without undue loss; (4) the bank's ability to securitize and sell certain pools of assets; (5) the extent and ease of the bank's access to money markets and other sources of funding; (6) the adequacy of and ease of access to liquidity sources and the bank's ability to meet liquidity needs; (7) the level of securities pledged against liabilities; (8) the bank's ability to obtain borrowed funds from outside sources that are consistent with the bank's funding strategies; (9) the effectiveness of and the extent of compliance with the bank's policies and procedures for funding and managing liquidity, interest-rate risk, management information systems, and contingency funding plans; (10) the capability of management to properly identify, measure, monitor, and control liquidity; (11) the level of diversification of funding sources, both on- and off-balance sheet; (12) the extent of the bank's asset-liability and gap-management practices; and (13) the vulnerability of the bank's funding to adverse publicity, increased reputation risk, and lowered credit ratings.
5. *Sensitivity to market risk.*[8] Sensitivity to market risk reflects (1) the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect earnings or the economic value of capital; (2) the ability of management to identify, measure, monitor, and control exposures to market risk, given the bank's size, complexity, and risk profile; (3) the nature and complexity of interest-rate risk exposure arising from nontrading positions; and (4) where appropriate, the nature and complexity of interest-rate risk arising from trading and foreign operations.

Information Technology Assessment

The inclusion of an information technology (URSIT) assessment as a content heading or report page is optional.* An information tech-

6. Credit risk arises from the potential that a borrower or counterparty will fail to perform on an obligation.

7. Liquidity risk is the potential that a financial institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market liquidity risk").

8. Market risk is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.

nology assessment is *mandatory*, however, if an URSIT rating is assigned or if significant supervisory concerns exist.[9] Information technology activities should be evaluated based on the nature and extent of information technology risks, including management processes, architecture, integrity, security, and availability. The supporting rationale for composite or component IT ratings should be included. Examiners should note whether a list of technical exceptions was provided to management. It may be appropriate to include descriptions of electronic banking activities. The examiner's conclusions should also be reflected in the Analysis of Financial Factors or the Management/Risk Management sections of the report, as appropriate. Any significant supervisory concerns should be reflected in the Matters Requiring Attention and in the Examination Conclusions sections.

Bank Secrecy and Anti-Money-Laundering Compliance

The content heading or report page is optional.* The section is *mandatory* if Bank Secrecy and Anti-Money-Laundering Compliance is assessed and a conclusion is rendered, or if significant supervisory concerns exist. BSA/AML compliance should be evaluated based upon the nature and extent of risk and non-compliance. Note whether a list of apparent violations or exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Fiduciary Activities Assessment

The content heading or report page is optional.* The heading or page is *mandatory*, however, if a trust (UITRS) or transfer-agent rating was assigned during the most recent Federal Reserve examination cycle or if significant supervisory concerns exist in these areas.[10] Fiduciary activities should be evaluated relative to management's oversight of fiduciary activities and the nature and extent of risk that the fiduciary activities or business lines evaluated present to the institution. Management's ability to assess the risk of fiduciary products and services offered, including new products, should be evaluated. Note whether a list of technical exceptions was provided to management. The supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in the Analysis of Financial Factors or the Management/Risk Management sections of the report, as appropriate. Significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Items Subject to Adverse Classification

The content heading or report page (and the associated content) is *mandatory*. The topic, however, must be discussed in the examination report. The Summary of Items Subject to Adverse Classification content heading or report page summarizes items classified by the examiner as either substandard, doubtful, or loss as of the examination date (for this page, considered the date relevant to the asset-quality review).[11]

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

9. See SR-99-8, "Uniform Rating System for Information Technology," and 64 Fed. Reg. 3,109 (January 20, 1999) for more information.

10. See SR-98-37, "Uniform Interagency Trust Rating System," and 63 Fed. Reg. 54,704 (October 13, 1998) for more information.

11. See SR-13-18, "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions."

may be effected in the future. Amounts classified *Loss* should be promptly charged off.

Total classifications also are presented for the previous examination. Reserve Banks that are engaged in alternate-year examination programs should provide totals contained in the previous examination report prepared by the state when applicable. The examiner also should consider creating a schedule under the Asset Quality content heading or page to detail classifications from additional prior examinations if meaningful trend information is noted. The examiner should also present, in the report narrative, classification trends for certain asset categories if the analysis is meaningful.

For the examinations of banks engaged in international lending, examiners should provide additional information to include categories for other credit-risk problems and value-impaired assets. Adjustments are required to be made for U.S. addressees and non-U.S. addressees.

For banks with foreign activity, the distinction between U.S. and non-U.S. addressees follows the definition set forth in the Call Report instructions: whether a customer is U.S. or non-U.S. is determined by the customer's principal address, that is, by its domicile. A U.S. address would be in the 50 states of the United States, the District of Columbia, Puerto Rico, or U.S. territories and possessions. Non-U.S. addressees include all other geographical areas.

The examiner should list in the appropriate category the amounts of all credits classified due to transfer risk. The value of credits shown as value impaired should be computed after deducting any allocated transfer-risk reserve that is established against an asset. In determining total classified assets, examiners should arrive at net assets classified due to country risk. Examiners should identify any credits classified due to transfer risk that have received the same or a more severe classification due to credit risk and that are listed above in the summary of classified items due to credit risk. The sum of such assets should be listed in the appropriate column and then deducted to arrive at net assets classified due to country risk. For the purpose of this content heading or report page, any credits classified as value impaired for transfer-risk purposes should not be included in the summary of credits classified due to credit risk, unless the credits are classified loss.

For the purpose of arriving at total classified assets, add the amount classified due to credit risk to net assets classified due to transfer risk for each category. When computing weighted classifications, the residual portion of any value-impaired assets should be assigned the same weight as substandard classifications. However, the residual exposure still remains value impaired for examination and classification purposes. Value-impaired assets held in the trading account should also be included in total classified assets but should not be considered classified assets when computing weighted classifications.

This report page also includes "Specific Items Subject to Adverse Classification." A full loan write-up is mandatory for all significant or material classified assets if (1) management disagrees with the disposition accorded by the examiner or (2) the institution will be rated composite "3," "4," or "5."[12]

Items Listed as Special Mention

The content heading or report page (and the associated content) is *mandatory*. The topic must be discussed in the examination report. The Summary of Items Listed for Special Mention content heading or report page presents the total of assets listed for special mention for the current and one previous examination. A special-mention asset is defined as follows:

A *Special Mention* asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special-mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant classification.[13]

The summary does not include assets listed for special mention when computing classification ratios. Reserve Banks that are engaged in alternate-year examination programs should rely on the special-mention total from the previous state's examination when applicable.

This report page also includes Specific Items Listed for Special Mention. A full loan write-up

12. SR-99-24, "Loan Write-Up Standards for Assets Criticized During Examinations."

13. See SR-93-30, "Interagency Policy Statements on Supervisory Initiatives Released Today." In particular, see the statement entitled, "Interagency Statement on the Supervisory Definition of Special Mention Assets."

is mandatory for all significant or material criticized assets if (1) management disagrees with the disposition accorded by the examiner or (2) the institution will be rated composite "3," "4," or "5."

Assets with Credit-Data or Collateral-Documentation Exceptions

The content heading or report page is optional.* The content heading is *mandatory* if examiners' ability to assess the loan files or overall asset quality at the bank is compromised because of inadequate information needed for loan line sheets or if the bank's loan administration systems and processes are deficient, particularly with respect to loan and collateral documentation and collateral values. If the credit data or collateral documentation exceptions are materially significant, this content heading or report page should provide support for a discussion of credit documentation practices under the Asset Quality content heading or report page.

Concentrations

The content heading or report page (and its associated content) is optional.* This page is *mandatory* if there are materially deficient practices in managing concentrations. If included, the content heading should include a discussion of the appropriateness of risk management practices regarding any materially significant concentrations of assets, liabilities, specific industries, and other categories, as applicable. This discussion should address the effectiveness of the bank's internal policies, systems, and controls to identify, monitor, and manage the risk associated with the concentrations and address the bank's alternatives or plans for reducing concentrations. Examination staff should comment on their ability to leverage the bank's internal concentration reporting when conducting the review and assessment of concentrations.

The content heading or report page should indicate that a concentration includes obligations, direct or indirect, of the same or affiliated interests that represent 25 percent or more of the bank's capital structure. The reader should also be informed that, for the purposes of this page, the capital structure is defined as tier 1 capital plus the allowance. See also SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach" and this manual's section entitled, "Concentrations of Credit."

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. The listing should include all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances, advances, letters of credit, and all other items due to the bank as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests.

Concentrations by industry, transfer risk, product line, type of collateral, and other characteristics should be detailed when appropriate. The listing should include amounts due from depository institutions, federal funds sold, and other assets in which payment depends on one financial institution or affiliated group and the total represents 25 percent or more of the bank's capital structure. Treasury securities, obligations of U.S. government agencies and corporations, and any assets collateralized by these items should not be included in the listing. The requirements of Regulation F (12 CFR 206), as they relate to concentrations involving correspondent banks, should also be considered.

Capital Calculations

The Capital Calculations page is optional.* Inclusion of capital calculations is mandatory, however, if (1) the bank has a financial subsidiary within the meaning of the Gramm-Leach-Bliley Act, (2) there is a change in the capital category as a result of the examination, or (3) the ratios supporting the capital category in the examination are not derived from the bank's Call Report as of the same date. The third exception could occur if the bank's examination ratios were calculated at a date other than the end of a quarter, or, if calculated at quarter-end, the numbers were adjusted or changed from those filed in the Call Report. It should be noted tier 2 capital and risk-weighted calculations are not required for banks that have opted in to the community bank leverage ratio framework.

Other Matters

This content heading or report page is optional.* If included, discuss issues or other matters of significance not covered elsewhere in the community bank's examination report. Discuss also significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the bank is engaged. If issues or concerns are noted, examiners should provide comments on specific areas, such as the following:

- accounting and internal controls
- affiliate relationships
- criminal referral procedures
- emergency preparedness
- financial recordkeeping and reporting regulations
- insurance
- investment in bank premises
- litigation
- security and controls against external crimes
- payments system risk
- nontraditional banking activities (for example, mortgage warehousing or data processing services)
- supervisory reporting
- nondeposit investment products

Other examination matters also may warrant comments on this report page.

Signature of Directors

The content heading is *mandatory*. A separate report page is required and should be the last page in the open section of the report.

Confidential Section

The "Confidential Section" is *mandatory*. This section of the bank examination report is mandatory. It must include all information that cannot or should not be disclosed or made available to the bank. It should also include internal administrative and supervisory information relevant to the Federal Reserve System and its staff. The order of the following headings or pages is at the examiner's discretion.

Directors and Officers

The content heading or report page is *mandatory* for inclusion in the report. A separate report page is required. All bank directors should be listed in alphabetical order. If the bank elects advisory directors, they should be listed alphabetically under a separate heading. Information requested in the report page header should be supplied for each director. Specific instructions for certain requested information are as follows:

- Under meetings missed, include all meetings a director has not attended between the previous (Reserve Bank or state) and current examination. If a director was elected since the previous examination, list only the number of meetings that they missed since the date of election.
- Under fees paid to each director, indicate whether the compensation is based on attendance.
- Under occupation or principal business affiliation, use concise and descriptive designations (for example, farmer, grocer, or commercial real estate developer).

For banks with active board committees, a code or legend for all committees should be prepared, indicating committee memberships for each director. The Executive Officers portion of the report page uses the Regulation O (12 CFR 215) definition of executive officers, but other significant officers may be included at the examiner's discretion. Information requested by the report page should be supplied. Additional individuals to be reported may include persons without official designation who exercise considerable influence or executive officers excluded from the Regulation O definition by board resolution who actually maintain a high level of responsibility. Officers should be listed in order of title or position of responsibility, with dominant individuals shown first.

Specific instructions for the requested information for the report page are as follows:

- Examples of assigned areas of responsibility may include administration, policy formulation, lending, operations, or branch manager.
- A salary should indicate the current annual salary. The total bonuses should be reported for the previous year.

If executive officers receive any other pertinent forms of compensation beyond their listed salary and bonus (such as commission-based pay, employment contracts, stock options, unusually large benefits, or affiliated bank salaries and fees), these should be discussed in narrative format below the listing of executive officers or on a separate page.

General Information

The content heading is *mandatory*. It includes (1) a discussion of strategic plans, future technology plans, planned bank products or services, or prospects for the bank; (2) significant or sensitive matters regarding the bank's management not previously addressed; (3) applicable comments on the extent that a particular insider controls or dominates the organization and any adverse effect of insiders on operating policies, procedures, or the overall financial condition of the bank; and (4) a discussion of any recommendations for supervisory actions and any additional material matters of a sensitive or confidential nature not previously addressed. To the extent not included on the Directors and Officers page, this discussion should also include a list of each of the major shareholders of the bank (those having 5 percent or more ownership) and their respective percentage of ownership. When the major shareholder is a bank holding company, its major shareholders and the percent controlled by each shareholder also should be listed. A listing of critical turnkey software vendors or information technology service providers as well as any client institutions for which processing services are provided should be included. Include any significant matters of a confidential nature regarding vendors or third-party service providers. Also include a description of any electronic banking activities.

COMMUNITY STATE MEMBER BANKS RATED COMPOSITE "4" OR "5"

The Federal Reserve has adopted a flexible, letter-format report in lieu of the standard, longer-form report for communicating the findings of on-site, safety-and-soundness examinations and inspections of community banking organizations that result in composite supervisory ratings of "4" or "5." Examiners may use a letter-format report for examination and inspections of community banking organizations rated "4" or "5," provided all mandatory and any applicable optional information is in the report.

The option of using a flexible letter-format for such community banking organizations will enable Reserve Banks to focus their reports on key findings and improve the communication of supervisory expectations to companies in need of significant improvement. In addition, given the increased examination frequency of community banking organizations with a "4" or "5" rating (typically every six months), the letter format will also hasten the communication of supervisory expectations.

Examiners are to follow the examination report guidance provided above for full-scope examinations of community banking organizations rated "1," "2," or "3."[14] That guidance provides for some flexibility in the structuring of the examination reports, so long as all mandatory and applicable optional content is covered. Examiners have flexibility in writing the narrative portion of reports.

Content of the Letter Format of Examination

A letter format report of examination for SMBs rated "4" or "5" should be tailored to fit the particular circumstances of the institution under review and should fully address the key areas that are routinely covered in the mandatory pages of the open and confidential sections of the standard report of examination.

These areas in the open section of the examination report include

- scope of the examination,
- summary of examination ratings,
- matters requiring attention,
- conclusions regarding management and risk management (addressing risk factors and the adequacy of risk management associated with risk levels and trends, which includes a risk-assessment matrix),
- analysis of financial factors,
- summary of items subject to classification or listed as special mention,
- signature of directors, and
- any applicable areas that are described as optional pages in the standard report of examination instructions and are necessary to support examiners' findings. Examples of these areas include compliance with enforcement actions and apparent violations of laws or regulations.

14. The flexible letter format may also be used on target examinations of 3-rated community banking organizations, as applicable.

These areas in the confidential section of the examination report include

- directors and officers, which includes information such as duties, length of service, and committee assignments; and
- general information about the institution, including sensitive matters not addressed in the open section of the report such as strategic and information technology plans, planned new products and services, insider influence, and recommended supervisory actions. If it is not included in the open section of the examination report, the risk assessment matrix can also be included in the confidential section of the examination report.

Communication of Supervisory Findings

As with standard reports of examination and inspection, the letter-format reports must notify a banking organization and its board of the organization's supervisory rating and the confidential nature of the letter. The letter-format report should also set forth the deadline by which the organization must reply to the Federal Reserve Bank, including the organization's plans to address any matters requiring immediate attention or matters requiring attention that are noted in the report. For more information, see this manual's section entitled, "Examination Strategy and Risk-Focused Examinations."

COMPLETION STANDARD FOR EXAMINATION AND INSPECTION REPORTS

Community Banks

Safety-and-soundness examination and inspection reports for community banking organizations issued by the Federal Reserve should be completed and sent to the supervised institution within a maximum of 60 calendar days following the "close date" of the examination. These standards apply to formal examination and inspection reports for institutions supervised by the Federal Reserve with less than $10 billion in total consolidated assets, including SMBs, bank holding companies, savings and loan holding companies, Edge Act and agreement corporations, U.S. branches and agencies of foreign banks, and foreign subsidiaries and branches of U.S. banks.[15] 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 "close date" of an on-site examination and inspection is defined as the last date that the examination team is physically on-site at the institution. For examinations and inspections for which all or a portion of the work is performed off-site, the "close date" is defined as the earlier of the following dates: (1) the date when the analysis (including loan file review) is completed and ready for the EIC's review or (2) the date when the preliminary exit meeting is held with management, which can be conducted either on-site or off-site by conference call.

Further, to ensure that findings are communicated to a supervised institution in a timely manner, Reserve Banks should ensure that the duration between the start of an examination/inspection to the completion and delivery of an examination/inspection report does not exceed 90 days.[16] In cases when reports are subject to statutory requirements for other state or federal agency review, such as by the Consumer Financial Protection Bureau (CFPB),[17] Reserve Banks may exceed the guidelines included in SR-13-14, "Timing Standards for the Completion of Safety-and-Soundness Examination and Inspection Reports for Community Banking Organizations," at the discretion of senior management. However, deviations from these guidelines are expected to be rare. At the discretion of senior Reserve Bank management, additional exemptions from this 90-day guideline may be considered for examinations that are conducted simultaneously on multiple affiliated banks or examinations of larger complex community banking organizations that require additional

15. Bank and savings and loan holding companies with total consolidated assets of $3 billion or less are subject to a separate program that has different requirements for the issuance of reports of inspection. See SR-13-21, "Inspection Frequency and Scope Expectations for Bank Holding Companies and Savings and Loan Holding Companies that are Community Banking Organizations."

16. The start date is the date that Reserve Bank examiners and supervisory staff commence the examination and inspection work, excluding pre-examination visitations and preparation.

17. See sections 1022, 1024, and 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For more information on the coordination of supervisory activities with the CFPB, see also the "Memorandum of Understanding on Supervisory Coordination" and the June 4, 2012, press release.

time on-site to review specialized or complex business lines.

In addition, findings and conclusions delivered to a supervised institution at the close date and exit meetings for examinations and inspections must be consistently documented in work papers.[18] At a minimum, documentation should include:

1. a list of attendees at the meetings;
2. a description of significant examination and inspection findings discussed, including preliminary ratings; and
3. a summary of the bank management's views on the findings and, if applicable, the views of the board of directors.

18. In some cases, Reserve Bank examiners or supervisory staff may conduct a pre-exit meeting with the institution's management at the close date of the examination or inspection. Representatives from the on-site examination or inspection team may also hold a final exit meeting with the institution after vetting examination or inspection findings with the responsible Reserve Bank officer(s). An "exit meeting" is defined as an examiner's meeting with the institution's management or management and board of directors to communicate preliminary supervisory findings and conclusions.

To the extent conclusions in the final report differ from those discussed at the close date and exit meetings, Reserve Bank examiners and supervisory staff should communicate the reasons for the differences to the supervised institution and document these discussions in their work papers. (See SR-13-14.)

COMMUNITY BANK REPORT OF EXAMINATION ILLUSTRATIVE TEMPLATE

The following pages provide an illustrative template of the community bank report of examination. Detailed descriptions of the report of examination pages are provided above in the subsection entitled, "Community Bank Report of Examination Instructions." The following template also contains clarifying instructions to examination staff, which are noted by the italicized text.

COMMUNITY BANK
REPORT OF EXAMINATION

Restricted FR

Name: ____________________	Financial statement date: ____________
Location: ____________________	Start date: ____________________
RSSD ID number: ______________	

THIS REPORT OF EXAMINATION IS STRICTLY CONFIDENTIAL

This document has been prepared by an examiner selected or approved by the Board of Governors of the Federal Reserve System. The document is the property of the Board of Governors and is furnished to directors and management for their confidential use. The document is strictly privileged and confidential under applicable law, and the Board of Governors has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 U.S.C. 1817(a) and 1831m) and in the regulations of the Board of Governors (12 CFR pt. 261 subpart C).

Under no circumstances should the directors, officers, employees, trustees or independent auditors disclose or make public this document or any portion thereof except in accordance with applicable law and the regulations of the Board of Governors.

Any unauthorized disclosure of the document may subject the person or persons disclosing or receiving such information to the penalties of section 641 of the U.S. Criminal Code (18 U.S.C. 641).

Each director or trustee, in keeping with his or her responsibilities, should become fully informed regarding the contents of this document. In making this review, it should be noted that this document is not an audit, and should not be considered as such.

FEDERAL RESERVE BANK OF [*Insert name of bank*]

REPORT OF COMMERCIAL BANK EXAMINATION

Name of bank Street City

County State Zip code

Mailing address

___ Joint ___ Concurrent ___ Independent

Federal Reserve Bank Examiner-in-Charge ______________________________

Federal Reserve Bank Nominee Examiner-in-Charge ______________________________

(FOR JOINT EXAMS ONLY) Participating Agency Examiner-in-Charge ______________

TABLE OF CONTENTS

Note: Except as indicated, amounts in tables are shown to the nearest thousand dollars.

Scope

Summary of Examination Ratings[1]

Uniform Financial Institution Rating System	Current exam	Prior Exam	Prior exam
Start Date	________	________	________
Regulatory Agency	________	________	________
Financial Statement Date	________	________	________
Composite Rating	________	________	________
Component Ratings	________	________	________
Capital	________	________	________
Asset Quality	________	________	________
Management	________	________	________
Earnings	________	________	________
Liquidity	________	________	________
Sensitivity to Market Risk	________	________	________
Risk Management	________	________	________
Uniform Rating System for Information Technology			
Information Technology Composite Rating	________	________	________
Information Technology Component Ratings			
Audit	________	________	________
Management	________	________	________
Development and Acquisition	________	________	________
Support and Delivery	________	________	________

1. Detailed definitions of examination ratings can be found in the *Commercial Bank Examination Manual* and 61 Fed. Reg. 67,021 (December 19, 1996).

	Current Exam	Prior Exam	Prior Exam
Uniform Interagency Trust Rating System			
Trust Composite Rating	______	______	______
Managment	______	______	______
Operations, Internal Controls, and Auditing	______	______	______
Earnings	______	______	______
Compliance	______	______	______
Asset Management	______	______	______
Other Composite Ratings	Date	Rating	
Consumer Compliance	______	______	
Community Reinvestment Act	______	______	

Composite Rating Definition

Examination Conclusions[2]

Apparent Violations of Laws and Regulations

2. Any institution about which the Federal Reserve makes a written material supervisory determination is eligible to utilize the appeals process as described in the Appeals Process and Board Ombudsman (Ombuds) Policy Statement (See also 85 Fed. Reg. 15,175 (March 17, 2020)). The Ombuds can provide assistance regarding questions related to the appeals process and claims of retaliation as well as assist in facilitating the informal resolution of a supervised institution's concerns prior to the filing of a formal appeal. For more information about the Ombuds, please visit the Federal Reserve Board's website.

Matters Requiring Attention[3]

Template Instruction: Include material issues that require the attention of the institution's board and/or senior management in order of importance. Include a brief summary statement regarding the status of prior examination Matters Requiring Attention. Status should communicate if all, most, none, etc. of the required items were addressed. Detailed assessment of each of the prior Matters Requiring Attention is not required. An example of text could include, "All previous Reserve Bank findings are considered to be satisfactorily addressed, unless otherwise noted in this Report of Examination." The comment should, however, provide a reference to any section of the report where issues that are repeated or incomplete are discussed, if applicable. Repeat Matters Requiring Attention, that were not previously considered addressed, should be noted as such in the details of this section.

Directorate Responsibilities

Each member of the board is responsible for thoroughly reviewing this Report of Examination. Each director must sign the Signatures of Directors page at the conclusion of this report, which affirms that he or she has reviewed the Report in its entirety.

EIC Name Examiner-in-Charge Federal Reserve Bank of [Insert name of the bank]	(if applicable)

3. Supervisory follow-up may consist of Matters Requiring Immediate Attention (MRIAs) and Matters Requiring Attention (MRAs). The key distinction between MRIAs and MRAs is the nature and severity of matters requiring corrective action, as well as the immediacy with which the banking organization must begin and complete corrective actions. MRIAs and MRAs will remain open until resolution and examiners confirm the banking organization's corrective actions. See SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings," for more information. When issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners will not criticize an institution for a "violation" of supervisory guidance (as supervisory guidance is not legally binding). When appropriate, examiners may reference (including in writing) supervisory guidance to provide examples of safe-and-sound conduct, appropriate risk-management practices, and other approaches to addressing compliance with applicable statutes or regulations. See 12 CFR pt. 262, Appendix A, "Statement Clarifying the Role of Supervisory Guidance."

Compliance with Enforcement Actions

Template Instruction: The Compliance with Enforcement Actions content heading or report page is optional. The heading or page is mandatory, however, if the institution is under a formal or informal supervisory action. An assessment that summarizes the institution's overall compliance with the action should be included in this section of the report. The examiner should include the level of compliance for each provision and provide detailed analysis that includes how compliance was achieved or detail what actions have been taken and what actions are necessary to achieve full compliance, as appropriate. A detailed assessment of provisions that have been in full compliance for more than one examination is not required.

Management/Risk Management

Template Instruction: Provide the risk management numerical rating and discussion of risk factors and the adequacy of risk management associated with risk levels and risk trends. The impact of specialty examination areas on relevant risk areas should be incorporated. For example, the impact of any information technology concerns on operational and other relevant risks should be discussed as well as the impact on legal or other risks of any findings with respect to fiduciary activities or compliance concerns. As applicable, examiners should communicate conclusions/findings of any evaluation of the adequacy of an institution's audit department/program as part of this section. Findings can be communicated as part of the overall Management comments, or as a standalone "Audit" subsection within the Management/Risk Management section.

Management/Risk Management[4] - [Insert management rating]/[Insert risk management rating]

(Comment is mandatory)

Template Instruction: A risk assessment matrix shall be included in this section of the examination report or in the confidential section, as appropriate.

Risk Assessment Matrix

Risk type	Inherent risk	Adequacy of risk management	Composite risk	Trend
Overall	______	______	______	______
Credit	______	______	______	______
Market	______	______	______	______
Liquidity	______	______	______	______
Operational	______	______	______	______
Legal	______	______	______	______
Compliance	______	______	______	______

Operational Risk *(Comment is mandatory)*

Legal and Compliance Risks *(Comment is mandatory)*

4. Supporting comments for credit, market, and liquidity risks, if not discussed in this section, may be found under their respective components in the Analysis of Financial Factors section.

Analysis of Financial Factors

Template Instruction: Include analysis and conclusions for each financial component in this section using subheadings to depict ratings and analysis of individual components and other topics of discussion. The order is optional; however, the more significant issues should be addressed up front. Narrative comments and support should generally be brief for 1- and 2-rated components and increase in detail and specificity for 3-, 4-, and 5-rated components.

Financial tables below can be customized to match the conclusions, risk, and messages being communicated to institution management. Nonapplicable ratios should be removed or denoted as not applicable with "N/A" in all nonapplicable columns.

Capital Adequacy – [*Insert rating, comment is mandatory*]

Ratios	Bank *Date*	Peer *Date*	Bank *Date*	Bank *Date*
Tier 1 Leverage Capital[5]	________	________	________	________
Common Equity Tier 1 Capital Ratio[6]	________	________	________	________
Tier 1 Risk-Based Capital/Risk-Weighted Assets[7]	________	________	________	________
Total Risk-Based Capital/Risk-Weighted Assets	________	________	________	________
Cash Dividends/Net Income	________	________	________	________

5. Tier 1 Capital/Average Total Assets.
6. Common Equity Tier 1 Capital/Total Risk-Weighted Assets.
7. Risk-Weighted Assets used in the above calculations can be found in the institution's Uniform Bank Performance Report, unless otherwise noted.

Asset Quality – [*Insert rating, comment is mandatory*]

Ratios	Current asset review	Prior asset review *(Date)*	Prior asset review *(Date)*
Total Adversely Classified Assets/ Tier 1 Capital + Allowance[8]	____________	____________	____________
Weighted Adversely Classified Assets[9]/ Tier 1 Capital + Allowance	____________	____________	____________

Ratios	Bank *(Date 1)*	Peer *(Date 1)*	Bank *(Date 2)*	Bank *(Date 3)*
90+ Days Past Due and Nonaccrual Loans and Leases/Loans and Leases	_________	_________	_________	_________
Net Loan Loss/Total Loans	_________	_________	_________	_________
Allowance/Total Loans	_________	_________	_________	_________

Credit risk *(Comment is mandatory)*

8. Allowance refers to allowance for loan and lease losses or allowance for credit losses. For more information on the calculation of the denominator of this ratio, see SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," and the *Commercial Bank Examination Manual.*

9. Weighted Adversely Classified Assets is the summation of each classification category utilizing the following weights: Substandard 20 percent, Doubtful 50 percent, and Loss 100 percent.

Earnings — [*Insert rating, comment is mandatory*]

Ratios	Bank *(Date)*	Peer *(Date)*	Bank *(Date)*	Bank *(Date)*
Return on Average Assets[10] (Subchapter S)	________	________	________	________
Net Interest Margin[11]	________	________	________	________
Noninterest Income/Average Assets	________	________	________	________
Noninterest Expense/Average Assets	________	________	________	________
Provision Expense/Average Assets	________	________	________	________

Liquidity – [*Insert rating, comment is mandatory*]

Ratios	Bank *(Date)*	Peer *(Date)*	Bank *(Date)*	Bank *(Date)*
Net Noncore Funding Dependence[12]	________	________	________	________
Core Deposits/Assets	________	________	________	________
Net Loans and Leases/Deposits	________	________	________	________
Liquid Assets/Total Assets	________	________	________	________

Liquidity Risk *(Comment is mandatory)*

10. Net Income/Average Assets ratio may be adjusted for Subchapter S status, if applicable.
11. Net Interest Income/Average Earning Assets.
12. (Noncore Liabilities *less* Short Term Investments)/Long Term Assets.

Sensitivity to Market Risk — [*Insert rating, comment is mandatory*]

	Model Results as of mm/dd/yyyy						
Market Risk Metrics	-200	-100	Limit	+100	Limit	+200	Limit
Change in EVE %	_______	_______	_______	_______	_______	_______	_______
Change in EVE % (prior year)	_______	_______	_______	_______	_______	_______	_______
Change in EAR %	_______	_______	_______	_______	_______	_______	_______
Change in EAR % (prior year)	_______	_______	_______	_______	_______	_______	_______

Market Risk *(Comment is mandatory)*

Information Technology Assessment

Information Technology – [*Insert rating(s)*]

Template Instruction: Section is mandatory if an information technology (URSIT) rating is assigned or if significant supervisory concerns exist. Information technology activities should be evaluated based upon the nature and extent of information technology risks including management processes, architecture, integrity, security and availability. Supporting rationale for composite and/or component IT ratings should be included. Note whether a list of technical exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Bank Secrecy & Anti-Money-Laundering Compliance

Template Instruction: Section is mandatory if Bank Secrecy Act (BSA) and Anti-Money-Laundering (AML) compliance is assessed and a conclusion is rendered, or if significant supervisory concerns exist. BSA/AML compliance should be evaluated based upon the nature and extent of risk and noncompliance. Supporting rationale for the conclusion should be included. Note whether a list of violations or exceptions was provided to management. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Fiduciary Activities Assessment

Fiduciary Activities Assessment – [*Insert rating(s)*]

Template Instruction: Section is mandatory if a trust (UITRS) or transfer agent rating is assigned during the most recent Federal Reserve examination cycle or if significant supervisory concerns exist in these areas. Fiduciary activities should be evaluated relative to management's oversight of fiduciary activities and the nature and extent of risk to the institution represented by the fiduciary activities or business lines evaluated. Management's ability to assess the risk of fiduciary products and services offered, including new products, should be evaluated. Note whether a list of technical exceptions was provided to management. Supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in Analysis of Financial Factors and/or the Management/Risk Management sections of the report, as appropriate, and any significant supervisory concerns should be reflected in the Matters Requiring Attention and Examination Conclusions sections.

Items Subject to Adverse Classification

Includes assets and off-balance-sheet items which are detailed in the following categories:

Substandard Assets—A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets—An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets—An asset classified Loss is considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified Loss should be promptly charged off.

Summary of Items Subject to Adverse Classification

		ADVERSELY CLASSIFIED			
CATEGORY		Sub-standard	Doubtful	Loss	Total
Loans and Leases		______	______	______	______
Securities		______	______	______	______
Other Real Estate Owned		______	______	______	______
Other Assets		______	______	______	______
Other Transfer Risk		______	______	______	______
Subtotal		______	______	______	______
Contingent Liabilities		______	______	______	______
Totals at Current Asset Review	(Date) ______	______	______	______	______
Totals at Prior Asset Review	(Date) ______	______	______	______	______
Totals at Prior Asset Review	(Date) ______	______	______	______	______
Totals at Prior Asset Review	(Date) ______	______	______	______	______

Specific Items Subject to Adverse Classification

	CATEGORY		
Amount, description, and comments	Substandard	Doubtful	Loss

Items Listed as Special Mention

Includes assets and off-balance sheet items which are detailed as follows:

Special Mention Assets–A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Summary of Items Listed as Special Mention

	Current asset review	Prior asset review	Prior asset review	Prior asset review
Total Special Mention				

Specific Items Listed for Special Mention

Description	Amount

Assets with Credit Data or Collateral Documentation Exceptions

Include assets with technical defects not corrected during the examination for which deficiency the appropriate number or description is noted in the “Deficiency” column.

1 – Appraisal
2 – Title Search or Legal Opinion
3 – Borrowing Authorization
4 – Recordation
5 – Insurance
6 – Collateral Assignment
7 – Financial Statement
8 – Inadequate Income/Cash Flow Information
9 – Livestock Inspection
10 – Crop Inspection
11 – Other

Name or description	Amount	Date of most recent financial statement	Deficiency description

Template Instruction: The content heading or report page is optional. The content heading is mandatory if examiners' ability to assess the loan files or overall asset quality at the bank is compromised because of inadequate information needed for loan line sheets or if the bank's loan administration systems and processes are deficient, particularly with respect to loan and collateral documentation and collateral values. If the credit-data or collateral-documentation exceptions are materially significant, this content heading or report page should provide support for a discussion of credit-documentation practices under the Asset Quality content heading or report page.

Concentrations

Template Instruction: The content heading or report page is optional. This page is mandatory if there are materially deficient practices in managing concentrations. If included, the content heading should include a discussion of the appropriateness of the bank's risk management practices regarding any materially significant concentrations in assets, liabilities, specific industries, and/or other categories, as applicable. Examiners should include the basis criteria for identifying a specific concentrations. In general, the baseline threshold of a concentration is 25 percent or more of the bank's capital structure (capital structure for the purposes of concentrations being tier 1 capital plus the allowance). For more information, see SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," and the Commercial Bank Examination Manual section entitled, "Concentrations of Credits."

Capital Calculations[13]

Template Instruction: The Capital Calculations page is Optional. Inclusion of capital calculations is mandatory, however, if (1) the bank has a financial subsidiary within the meaning of the Gramm-Leach-Bliley Act, (2) there is a change in the capital category as a results of the examination, or (3) the ratios supporting the capital category in the examination are not derived from the bank's Call Report as of the same date. The third exception could occur if the bank's examination ratios were calculated at a date other than the end of a quarter, or, if calculated at quarter-end, the numbers were adjusted or changed from those filed in the Call Report.

	Current $(000s)	Date $(000s)
Tier 1 Capital		
Common Stock	________	________
Surplus	________	________
Undivided Profits and Capital Reserves	________	________
Does not include appreciation (depreciation) on held-to-maturity and available-for-sale securities.		
Noncumulative Perpetual Preferred Stock & Surplus	________	________
Minority Interests	________	________
Subtotal: Tier 1 Capital Elements	________	________
Less		
Other Adjustments	________	________
Tier 1 Capital		
Tier 2 Capital		
Allowance	________	________
Adjusted Allowance		
Less		
Eligible Allowance	________	________
Cumulative Perpetual Preferred Stock	________	________
Subordinated Debt	________	________
Other	________	________
Tier 2 Capital (Not to Exceed 100% of Tier 1 Capital)		
Total Capital	________	________
Tier 1 Plus Tier 2 Capital	________	________
Less Deductions	________	________
Total Capital		

13. Tier 2 capital and risk-weighted calculations are not required for banks that have qualified for and have opted in to the Community Bank Leverage Ratio framework.

Risk-Weighted Assets and Average Total Assets Calculations

Risk-Weighted Balance Sheet Items	________	________
Risk-Weighted Off-balance-sheet Items	________	________
Less: Risk-Weighted Amounts Deducted from Capital	________	________
Gross Risk-Weighted Assets	________	________
Less: Ineligible Portion of allowance & ATRR	________	________
Total Risk-Weighted Assets	________	________
Average Total Assets	________	________
Less: Amounts Deducted from Tier 1 Capital	________	________
Adjusted Average Total Assets	________	________
Memoranda	________	________
Securities Appreciation (Depreciation)	________	________
Contingent Liabilities/Potential Loss	________	________

Other Matters

Signature of Directors

We the undersigned directors of ______________________________

have personally reviewed the contents of the Report of Examination dated ______________

Signature of Directors	**Date**
______________________________	______________
[Name, Title]	
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________
______________________________	______________

NOTE: This form should remain attached to the Report of Examination and be retained in the bank's file for review during subsequent examinations. The signatures of committee members will suffice only if the committee includes outside directors and a Resolution has been passed by the full board delegating the review to such committee.

Confidential Section – Directors and Officers

List alphabetically all directors/trustees, executive officers, and principal stockholders. Also indicate their titles. Number of shares owned is not rounded. (J – indicates stock jointly owned; P – indicates preferred stock owned; H – indicates holding company stock owned; C – indicates stock controlled but not owned). For directors, indicate the area of professional expertise (such as law, marketing, lending, mergers/acquisitions) and the type and date of director training attended.

Name and committees City, State Year of birth	Meetings missed[14]	Years on board	Shares owned	Compensation (Bonus)	Occupation or principal business
Chair					
Directors					
Advisory Directors					
Principal Officers/Not Directors					

14. Number of meetings missed since previous examination.

Regular schedule of directors' meetings ______________________________

Fee paid each director ______________________________

Committees ______________________________

____

____

____

____

Confidential Section – General Information

Include a discussion of strategic plans, future technology plans, planned bank products or services, and/or prospects for the bank; significant or sensitive matters regarding the bank's management not previously addressed; applicable comments on the extent a particular insider controls or dominates the organization and any adverse effect of insiders on operating policies, procedures, or overall financial condition of the bank; and a discussion of any recommendations for supervisory actions and any additional material matters of a sensitive or confidential nature not previously addressed. To the extent not included on the Directors and Officers page, this discussion should also include a list of each major shareholder of the bank (5 percent or more) and the respective percentage of ownership. When the major shareholder is a bank holding company, its major shareholders and the percent controlled should be listed. Include a listing of critical turnkey software vendors, and/or service providers, and any client institutions for which processing services are provided. Include any significant matters of a confidential nature regarding vendors or third-party service providers. In addition, include a listing of e-banking activities. The topics below are provided as examples for examiner consideration.

1. Discuss prospects for the bank including any strategic/technology plans and any new services planned.

2. Discuss any material matters regarding the bank's condition or management that are sensitive or confidential. If applicable, discuss the extent a particular insider controls or dominates the bank and any adverse effect of insiders on operating policies, procedures, or the financial condition of the bank.

3. Discuss any recommendations for supervisory action.

4. List each major (5 percent or more) shareholder or group and their percentage ownership. When the major shareholder is a bank holding company, list its major shareholders and their percent controlled.

Name	Shares Owned	Percent Owned

INTRODUCTION

The Federal Reserve follows a risk-focused supervisory approach for bank holding companies (BHCs), savings and loan holding companies (SLHCs), and state member banks (SMBs) whereby work is scaled to the asset size and complexity of an institution. An important aspect of this approach is the assessment and evaluation of practices across groups of supervised institutions with similar characteristics and risk profiles. This portfolio approach to supervision facilitates greater consistency of supervisory practices and assessments across comparable institutions and enhances the Federal Reserve's ability to identify an outlier institution among its established peer group.

Building on the "Examination Strategy and Risk Focused Examinations" section of this manual, this section summarizes the Federal Reserve's approach to supervising SMBs that are in the regional banking organization (RBO) portfolio. For purposes of this manual section, these institutions are referred to as "regional SMBs." While this section describes key aspects of the supervision process for regional SMBs, the *Bank Holding Company Supervision Manual* (BHCSM) contains additional information on the Federal Reserve's approach to supervising RBO holding companies. See section 1050.2 of the BHCSM.

Key aspects of the regional SMB supervisory approach include

- continuous monitoring and frequent bank-to-supervisor communications through a dedicated Reserve Bank central point of contact (CPC) for each regional SMB.
  - The CPC coordinates the supervision activities at a regional SMB. This includes organizing the supervisory planning process, executing supervisory activities as well as monitoring supervisory concerns, applications issues, meetings with management, and enforcement matters.
- coordinated approach to supervision with other regulators (for example, the state banking agencies and the Consumer Financial Protection Bureau or CFPB). This approach minimizes regulatory burden and ensures a consistent supervisory message among regulators.
- implementation of a customized supervisory plan, which the CPC leads in developing or revising annually based on a bank's risk profile.
- supervisory events or target examinations conducted throughout the year, culminating in an annual roll-up of the supervisory assessment of the BHC, including the bank.

DEFINITION OF REGIONAL BANKING ORGANIZATIONS

The Federal Reserve considers several factors, such as an institution's asset size, complexity of operations, and organizational structure in determining whether a bank or holding company is included in the RBO supervisory portfolio or in another supervisory portfolio. The RBO supervisory portfolio generally includes domestic holding companies and SMBs having total consolidated assets greater than or equal to $10 billion and less than $100 billion.

EXAMINATION AND TARGET EXAMINATION FREQUENCY AND SCOPE

State Member Bank Frequency and Scope

As discussed in the "Examination Strategy and Risk-Focused Examinations" section, the Federal Reserve is required to conduct a full-scope, on-site examination of every insured SMB at least once during each 12-month period, with the exception that small depository institutions meeting certain criteria can be examined once during each 18-month period.[1] A full-scope examination cycle for a regional SMB involves the collection and analysis of information sufficient to allow the CPC to determine a rating for each of the six CAMELS components and the composite rating consistent with the interagency guidance reflected in SR-96-38, "Uniform Finan-

1. See the Federal Reserve Board's Regulation H (12 CFR 208.64).

cial Institutions Rating System." The scope of an examination will increase in intensity when a regional SMB's financial and managerial condition deteriorate or are less than satisfactory.

In addition to the annual full-scope examination, examiners are expected to complete a target examination at each regional SMB during the supervisory cycle. Throughout the annual examination cycle, the Federal Reserve may perform several targeted examinations on a particular activity or risk-management function for all regional SMBs. As an example, targeted-scope examinations at regional SMBs might cover asset quality for a particular lending activity, allowance practices, the internal audit function, information technology, vendor risk management, liquidity risk, sensitivity to market risk, model risk management, Regulation O (12 CFR pt. 215), Regulation W (12 CFR pt. 223), and specific business lines. The use of target examinations is intended to reduce regulatory burden on a regional SMB, which can arise from one point-in-time examination when examiners are reviewing multiple activities and functions at the same time.

Loan Quality Review

A thorough review of a bank's loan and lease portfolios remains a fundamental element of the Federal Reserve's examination program for regional SMBs. As discussed in this manual's section, "Supervisory Loan Sampling at Regional Banking Organizations," Reserve Banks are expected to conduct at least two loan quality reviews during the annual supervisory cycle of a regional SMB.[2]

Regulation O Compliance

The Federal Reserve Board's Regulation O (12 CFR pt. 215) implements many of the laws pertaining to extensions of credit by banks to their insiders. Regulation O is designed to mitigate the potential for conflicts of interest and self-dealing by individuals who may be in a position to influence a bank's lending decisions. Examiners are expected to complete an annual assessment of a regional SMB's Regulation O compliance program. For more information, see this manual's section entitled, "Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks."

Review of Internal Audit

Every three years, Reserve Bank examiners are expected to conduct testing activities at RBOs as part of the audit infrastructure review. The review can be an independent supervisory event or conducted jointly or concurrently with a state banking agency. The purpose of the internal audit review is to conduct an overall assessment of the bank's internal audit function and to determine whether the audit function and processes are effective or ineffective. If the audit function and its processes are effective, examiners can rely on the work of the bank's internal audit function as part of the supervisory review process. For regional SMBs, Reserve Bank examiners should review internal audit documentation throughout the year as well as meet with the bank's internal and external auditor to determine whether examiners can continue to the rely on the work of the bank's internal audit function. The following SR letters provide more guidance on the assessment of a bank's internal audit function:

- SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing"
- SR-13-1/CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing"

Specialty Areas: Bank Secrecy Act, Information Technology, and Trust

Each annual safety-and-soundness examination cycle of a regional SMB includes an assessment and evaluation of the Bank Secrecy Act (BSA)/ anti-money-laundering (AML) compliance program. This assessment is required by statute at SMBs and U.S. branches or agencies of foreign banking organizations (12 U.S.C. 1818(s)(2) and 12 U.S.C. 1818(b)(4)).[3] For more

2. SR-14-4, "Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Bank Holding Companies in the Regional Banking Organization Supervisory Portfolio."

3. Some SMBs are on an alternate examination program with state supervisory agencies where the Federal Reserve and a state banking agency alternate which supervisor will lead the

information, see the section of this manual entitled, “Regulation H: Bank Secrecy Act and Anti-Money-Laundering.”

The Federal Reserve integrates information technology (IT) supervision within the overall risk-focused supervisory process. Each annual safety-and-soundness examination cycle of a regional SMB includes an assessment and evaluation of IT risks and risk management. See SR-00-3, “Information Technology Examination Frequency,” for more information. The scope of the IT assessment should generally be sufficient for Reserve Bank examiners to assign a bank with a composite rating under the Uniform Rating System for Information Technology (URSIT). See SR-99-8, “Uniform Rating System for Information Technology,” and 64 *Federal Register* 3109 (January 20, 1999).

Much like IT examinations, the Federal Reserve integrates trust examinations into the safety-and-soundness examinations at regional SMBs. Trust examination frequency varies based on the effect of fiduciary activities on the bank’s overall risk profile (table 1). At a minimum, examiners should review fiduciary activities no less frequently than during every other routine safety-and-soundness examination. At complex fiduciary institutions, examiners should update the composite Uniform Interagency Trust Rating System (UITRS) rating and transfer agent ratings (as applicable) annually. Any material findings related to these areas should be included in the annual summary supervisory report and any significant concerns should be reflected in the safety and soundness examination ratings. See SR-01-5, “Examination of Fiduciary Activities.”

examination. If the state banking agency does not include a BSA/AML compliance review in the regional SMB examination scope, Reserve Banks should undertake a BSA/AML compliance review, either as part of the state examination or as a separate targeted review within the same examination cycle.

CONTINUOUS MONITORING

Compared to the point-in-time supervision of community banks, the supervision program for regional banks emphasizes ongoing supervision through increased planning and continuous monitoring. By emphasizing planning and monitor-

Table 1. Key examination activities and frequency for regional state member banks

Functional area	Frequency	Source document/guidance
Safety and soundness examination of the state member bank	12 months	12 CFR 208.64 and SR-18-7
Regulation O compliance assessment	12 months	SR-14-4
Loan quality review	Two reviews every 12 months[1]	SR-14-4
Bank Secrecy Act/Anti-Money-Laundering compliance program assessment	12 months	12 U.S.C. 1818(s)(2) and SR-18-7
Information technology ratings assignment	12 months[2]	SR-00-3
Trust and transfer agent	In general, every other routine safety-and-soundness examination (2 years)	SR-01-5

1. One of the loan quality reviews can be completed during the full-scope safety and soundness examination.

2. Depending on where the IT function resides within the RBO and supervisory resources at the Reserve Bank, the IT examination can be conducted as a target supervisory event, part of the safety-and-soundness examination of the SMB, or part of the annual roll-up assessment of the holding company. In general, the Federal Reserve generally assigns IT ratings for the depository institution; however, an IT rating is assigned to the holding company or non-bank subsidiary when the IT function is managed at the consolidated organization level.

ing, examiners can focus supervisory activities on significant risks and issues.

The continuous monitoring framework is a foundational component of the overall supervisory strategy among regional SMBs. Continuous monitoring activities are supervisory activities designed to develop and maintain an understanding of the institution, its risk profile, and associated policies and practices. These activities also provide information that is used to assess inherent risks and internal control processes. Furthermore, continuous monitoring activities facilitate regular communication between CPCs and bank management and support the timely identification of risk trends, key developments, and strategic initiatives of the supervised institutions. Specifically, continuous monitoring activities aim to assess

- material developments at the bank, including significant changes or new strategic initiatives;
- new or emerging risks, risk trends, or areas of regulatory concern;
- the Capital, Asset Quality, Earnings, Liquidity, and Sensitivity to Market Risk (CAELS) ratings components of the CAMELS rating system with a focus on material changes and trends;
- the bank's risk profile, strategic initiatives, financial condition, emerging risk profile, or areas of supervisory concern;[4]
- whether any changes are necessary to the bank's supervisory ratings, supervisory actions, or the supervisory plan; and
- other relevant matters related to the bank's overall condition, operations, or geographic footprint.

To support the ongoing supervision through continuous monitoring, CPCs will regularly ask management at regional SMBs for information and reports that enable supervisory staff to assess the condition of the bank and set supervisory priorities for each regional SMB during the annual supervisory planning process. As part of the continuous monitoring process, CPCs will typically request various internal documents from the banks, such as risk-management reports, board and risk committee packets, meeting minutes—as well as scheduled discussions with key personnel, and financial performance reporting.

RBO SUPERVISIORY PLANNING PROCESS

Examiners develop several internal work products to organize and execute the supervision of regional SMBs. Complete and current Institution Overview (IO), Risk Matrix and Assessment (RA), and Supervisory Plan (SP) documents, collectively called the "IORASP," are critical to execute effective consolidated supervision of RBOs and regional SMBs. Reserve Bank staff generally complete and update the IORASP annually for RBOs, as these documents provide a comprehensive assessment of the firm and document the supervision plan. Furthermore, Reserve Bank staff should update IORASP documents when there are significant changes at the SMB RBO.

Institution Overview. Examiners start the supervisory process by developing an understanding of the institution and summarizing this information into the "Institution Overview." The Institution Overview provides the foundation for the annual supervisory plan, which sets forth the key areas of supervisory focus for the bank. The Institution Overview highlights the bank's riskiest and most material activities and business lines.[5] Among other things, the Institution Overview conveys the bank's present condition and its current and prospective risk profiles, organizational changes, an overview of material business lines as well as a summary of capital planning and the bank's IT profile.

Risk Assessment and Matrix. The Risk Assessment identifies significant risks and supervisory concerns at the regional SMB and provides a foundation for determining the supervisory activities to be conducted. Further, the Risk Assessment provides a commentary and analysis of the bank's risk profile, which covers six risk categories (credit, market, liquidity, operational, legal, and compliance).[6] A Risk Matrix is used to identify significant activities,

4. See SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion," as well as this manual's section entitled similarly.

5. Material business lines are considered the primary drivers of the institution's revenue generation, profitability, and franchise value.

6. SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion."

the type and level of inherent risks in these activities, and the adequacy of risk management over these activities. This information also aids examiners in determining composite risk assessments for each of these activities and the overall bank and promotes consistency in the review of a bank's risk-management practices.

Supervisory Plan. The Supervisory Plan represents a bridge between the Risk Assessment and the supervisory activities to be conducted at the regional SMB. In the Supervisory Plan, examiners organize information about a bank's key risk areas, revenue drivers, and emerging risk areas. The Supervisory Plan for regional SMBs also generally covers the scope of the Reserve Bank's loan file review;[7] reviews of information technology, trust, consumer compliance; and the BSA/AML compliance program.[8] The Supervisory Plan will also describe the reviews and anticipated work products at other entities or areas within the consolidated organization.

Lastly, Federal Reserve CPCs should also make an overall assessment as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the supervisory review process. Examiners should refer to SR-03-5, and SR-13-1/CA-13-1. Likewise, Federal Reserve examiners should also make an overall assessment on the effectiveness of the internal/external loan review function and the level of reliance that it can be given.

COORDINATION OF SUPERVISORY OBJECTIVES WITH OTHER REGULATORS

Another aspect of the supervisory planning process is the coordination of supervisory activities. The CPC should coordinate the supervisory planning process and examination/inspection program with the appropriate primary state regulators and functional regulators for affiliated subsidiaries in order to ensure that high-risk areas are appropriately reviewed and duplicative efforts are avoided.[9] CPCs should regularly communicate and coordinate with the state regulators to remain informed about examination findings and changes to the state regulators' supervisory assessments or strategies at the regional SMB. These coordination efforts extend to interactions with the CFPB, which is the primary regulator with respect to a number of federal consumer financial laws of depository institutions with total assets over $10 billion and their affiliates. More information on the Board's coordination activities with other regulators can be found in section 1050.2 of the BHCSM.

EXAMINATION PROCEDURES

RBO CPCs and examiners are expected to document their analysis in assigning CAMELS ratings at full-scope examinations and targeted reviews of regional SMBs. Examiners document their work by completing the relevant Examination Documentation (ED) modules.[10] In general, examiners complete the Core Analysis Decision Factors of the ED module procedures that directly address the six components of the CAMELS rating system. In addition, for a regional SMB's business or product lines[11] that represent 25 percent or more of its annual revenues,[12] Federal Reserve CPCs and examiners are expected to perform business and product line analysis to fully understand the bank's significant sources of revenues and expenses.

Federal Reserve examiners apply streamlined work programs to low-risk activities at regional SMBs. For more information on the assignment of risk at a bank and completion of examination procedures based on the bank's risk level, see SR-19-9, "Bank Exams Tailored to Risk (BETR)" and this manual's section entitled, "Federal Reserve System Bank Surveillance Program."

7. See section "Supervisory Loan Sampling at Regional Banking Organizations," of this manual and SR-14-4 for more information.

8. See SR-18-7, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations."

9. See SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion" and SR-96-33, "State/Federal Protocol and Nationwide Supervisory Agreement."

10. For more information on the ED modules, see this manual's section, "Community Bank Supervision Process," and the Board's ED modules website.

11. Business or product lines should be defined by the institution through internal management information systems or filings, such as the Securities and Exchange Commission's Form 10-K.

12. Annual revenue equals net interest income plus noninterest income.

Depending on the specific activities and characteristics of the regional SMB, Federal Reserve examiners may complete examination procedures over specialty areas or relevant lines of business. In these instances, examiners often use the relevant reference ED modules to guide their analysis and review of the bank.

REPORTS OF EXAMINATION

Reserve Banks are expected to communicate the CAMELS ratings to regional SMBs via a report of examination or supervisory letter every 12 months, and whenever a rating changes during the examination cycle.[13] As previously discussed, the supervision of regional SMBs can encompass a limited number of targeted reviews and off-site monitoring conducted throughout an annual examination cycle. After completing a targeted examination or supervisory event, examiners communicate supervisory findings in writing through a formal examination report, supervisory letter, or any other supervisory communication, which is generally directed to the bank's board of directors, or an executive-level committee of the board.[14] The presentation of the report of examination for a regional SMB subsidiary can vary based on the unique characteristics of the bank and the supervisory activities completed over the course of a year at the bank and its parent holding company. Other factors that contribute to the variability of the presentation of the report of examination for a regional SMB include

- the asset size and complexity of the consolidated holding company,
- the percent of the consolidated holding company's assets at the lead SMB subsidiary,
- the extent of intercompany transactions between the SMB subsidiary and the holding company,
- the number of target examinations completed over the course of the examination cycle, and
- the nature of the examination or supervisory event(s) the Reserve Bank conducts with the relevant state banking agency.

13. SR-99-17, "Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System."

14. SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings."

While a standalone examination report can be prepared and delivered to a regional SMB, in most cases, the CPC delivers a "combined roll-up" report to the board of directors of the consolidated organization. This combined roll-up includes a report of examination for the regional SMB, inspection ratings for the BHC as well as summarized supervisory findings, including the status of prior supervisory findings and conclusions of target assessments conducted during the annual supervisory cycle. The combined roll-up report should be used to the greatest extent possible for all regional SMB roll-up supervisory events where the Reserve Bank is the lead.

In 2019, the Federal Financial Institutions Examination Council (FFIEC) members agreed on a set of principles that should apply to the completion of reports of examination. The FFIEC members established a principles-based approach for completing the report of examination to promote consistency and communication among the agencies. These principles allow individual supervisors with the flexibility to document their assessment of the condition of supervised financial institutions based on their asset size, activities, risk profiles, and financial and managerial condition. See SR-19-6, "Federal Financial Institutions Examination Council Policy Statement on the Principles for Completing the Report of Examination."

Examination Report Instructions for State Member Banks in the Regional Banking Organization Supervisory Portfolio

This subsection provides detailed instructions for examiners completing examination reports resulting from full-scope examinations of regional SMBs.

The overall content of the examination report may differ based on the activities at the bank as well as the scope of examination activities. Examiners have some flexibility concerning the formatting of the report. For example, a cover page with the Reserve Bank's seal and the state banking agency's seal may be included. A sample cover page is provided in the section entitled, "Community Bank Supervision Process." Furthermore, examiners may include organizational information, such as a table of contents and a separate page, which defines acronyms that are used throughout the report.

In all instances, the examination report should explain that the contents of the report of examination contain confidential supervisory information and that the Board has forbidden its disclosure in any manner without its permission, except in limited circumstances specified in the law (12 U.S.C. 1817(a) and 1831m) and implementing regulations (12 CFR pt. 261, subpart C). This information may be conveyed on report cover sheet or in a footnote reference in the report of examination.

A transmittal letter should accompany the report of examination. Examiners should tailor the contents of the transmittal letter based on the bank and the results of the examination. Examiners should not repeat information that is in other sections of the examination report and should not comment on individual ratings components in the transmittal letter. Information that is generally conveyed in the transmittal letter includes

- regulatory agencies (Reserve Bank and state banking agency, as applicable) that participated on the examination or supervisory event;
- start date and end date of the examination. Consider including the timeframe of examination activities that were conducted off site;
- financial as-of date and asset quality date;
- brief description of related reviews or events within the supervisory cycle that have contributed to the assignment of ratings for the bank, including the appropriate timeframe;
- a brief summary of key supervisory messages, ratings changes, and outlook for supervisory activity in the upcoming cycle; and
- contact information of the central point of contact at the Reserve Bank and state banking agency, as appropriate.

Below is an outline of the report of examination. Sections or subsections marked with an asterisk (*) should be omitted if not applicable.

- Directorate Responsibility
- Scope
- Overall Risk Profile, Conclusions, and Key Supervisory Themes
  - — Overall Risk Profile*
  - — Overall Conclusions
  - — Bank Rating
  - — Key Supervisory Themes*
- Summary of Ratings
- Apparent Violations of Law*
- Supervisory Issues*
- Compliance with Enforcement Action*
- Management and Risk Management
- Financial Condition
  - — Assessment of Asset Quality, including Summary of Items Subject to Adverse Classification
  - — Assessment of Capital, Earnings, Liquidity, and Sensitivity to Market Risk
- Information Technology Assessment*
- Fiduciary Activities Assessment*
- Consumer Compliance Assessment
- Additional Supervisory Assessments
  - — Bank Secrecy Act and Anti-Money Laundering Compliance Program
  - — Audit Program*
  - — Other Matters*
- Signature of Directors

Report of Examination Instructions by Section

Directorate Responsibility

The Directorate Responsibility section is *mandatory*. This section informs board members that they are responsible for thoroughly reviewing the report of examination. Each director must sign the Signature of Directors page at the conclusion of this report. This section also includes standard language informing the institution of its right to appeal material supervisory determinations. See 85 *Federal Register* 15,175 (March 17, 2020) for more information on the Federal Reserve's appeals process.

Scope

The Scope section is *mandatory*. This section describes the scope of work performed during the examination and typically contains two concise paragraphs describing the following:

- financial information date,
- asset quality review date,
- the scope of the loan and commitments sampled and reviewed,
- management information systems (MIS) reviewed, and
- meetings conducted (such as the exit meeting).

Overall Risk Profile, Conclusions, and Key Supervisory Themes

This overall section is *mandatory*. However, certain subsections may be omitted if they are not applicable. Information about the applicability of the subsections is described below. One of the primary objectives of this section of the report of examination is to inform the bank's board of directors of overarching supervisory concerns that examination staff have identified during the examination or supervisory cycle.

Overall Risk Profile. For banks rated a composite "1" or "2," this subsection is optional. However, this subsection is *mandatory* if the bank is rated a composite "3," "4," or "5." In either case, the Overall Risk Profile should be one paragraph in length and provide context to the analysis in the Overall Conclusions subsection. This subsection should describe key drivers for the risk profile of the bank, which could include a description of specific risk stripes. The Overall Risk Profile subsection should not include the risk matrix, nor should the subsection repeat information that is discussed elsewhere in the report, particularly the Management and Risk Management section and the Financial Condition section.

Overall Conclusions. This subsection is *mandatory*. In approximately two paragraphs, examiners should describe

- overall bank ratings,
- justification for the ratings,
- assessment of the financial condition and risk management, and
- key supervisory messages for the institution.

If key supervisory messages require more detail, examiners should include the Key Supervisory Themes subsection, which is described below.

Bank Rating. Describing the bank's composite Uniform Financial Institutions Rating System (UFIRS) rating is *mandatory*. The rating description should include a qualitative description of the condition of the bank as well as the numeric rating. Examiners should include a reference to the appropriate ratings guidance in a footnote. If the bank is rated a composite "3," "4," or "5," examiners also should provide a definition of the composite rating in the footnote. The italicized text below and supporting footnote text provides an example of communicating a composite "3" CAMELS rating in the report of examination:

> *The Bank remains in less than satisfactory condition and is rated a composite "3" according to the Uniform Financial Institutions Rating System.*[15] *Ratings are assigned on a scale from 1 to 5 in ascending order of supervisory concern.*

Key Supervisory Themes. This subsection is optional. The purpose of this subsection is to describe overarching issues at the bank and areas of supervisory focus. Each supervisory theme should be significant to the financial or operating condition of the organization and/or its strategic direction. In determining whether to include this subsection in the report of examination, examiners should consider the bank's condition, severity of findings, risk profile, and other significant factors. For example, a Supervisory Themes subsection may be appropriate for a bank with a risk profile that raises more than normal supervisory concern, or any other material items or findings that examiners want to communicate to the board and senior management. Key supervisory themes may include a discussion of the root causes for findings or apparent violations, particularly if there is a large volume of findings or severe findings/apparent violations that were uncovered during the examination. Examiners can also use Key Supervisory Themes to communicate focus areas for the upcoming supervisory cycle. If there are multiple supervisory themes, examiners should describe each theme in concise paragraphs separating each theme with a header.

15. See SR-96-38, "Uniform Financial Institutions Rating System," the *Commercial Bank Examination Manual* and 61 Fed. Reg. 67,021 (December 19, 1996). *Rating 3.* Financial institutions with a composite "3" rating exhibit some degree of supervisory concern in one or more of the component areas. These institutions have a combination of moderate to severe weaknesses; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated composite "1" or "2." Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure of the institution appears unlikely, however, given its overall strength and financial capacity.

Summary of Ratings

The Summary of Examination Ratings section is *mandatory*. All supervisory ratings assigned during the examination and for the two previous examinations should be provided (table 2). Include any specialty or targeted examination ratings assigned or other assessments during the recent Federal Reserve examination cycle.

Table 2. Summary of ratings

	Current examination [Insert start date] [Insert lead agency]	**Prior examination [Insert start date] [Insert lead agency]**	**Prior examination [Insert start date] [Insert lead agency]**
Composite Rating	#	#	#
Component Ratings			
Capital	#	#	#
Asset Quality	#	#	#
Management	#	#	#
Earnings	#	#	#
Liquidity	#	#	#
Sensitivity to Market Risk	#	#	#
Risk Management	#	#	#
Information Technology Composite Rating	#	#	#
Information Technology Component Ratings			
Audit	#	#	#
Management	#	#	#
Development and Acquisition	#	#	#
Support and Delivery	#	#	#
Fiduciary Activities Composite Rating	#	#	#
Fiduciary Activities Component Ratings			
Management	#	#	#
Operations, Internal Controls, and Auditing	#	#	#
Earnings	#	#	#
Compliance	#	#	#
Asset Management	#	#	#
Additional Supervisory Assessments	***Date of Review***	***Assessment/Rating***	
Audit	#	#	
Bank Secrecy Act/ Anti-Money-Laundering	#	#	
Consumer Compliance	#	#	
Community Reinvestment Act	#	#	

Apparent Violations of Law

The Apparent Violations of Law section is optional. However, when examiners identify apparent violations of federal or state banking statutes and regulations, it is *mandatory* to include this section in the report of examination. A heading for each apparent violation listed should name the applicable statute and/or regulation and provide a brief description of what the law covers. This summary should be followed by a brief description of the requirements of the statute and/or regulation and a discussion of how or why the apparent violation occurred. Examiners should indicate whether the apparent violation is isolated (e.g., management generally understands the statute or regulation but missed one instance) or systemic (e.g., management was not aware of or did not understand fully the statute or regulation). Furthermore, examiners should describe the bank's completed corrected actions as well as planned corrective actions, including proposed timelines for resolution.

Supervisory Issues

The Supervisory Issues section can be omitted if there are no new or outstanding issues. However, the section is *mandatory* if the bank has any supervisory findings, such as Matters Requiring Immediate Attention (MRIAs) or Matters Requiring Attention (MRAs).[16] This section is intended to highlight the supervisory issues for the use of the board of directors and the bank's management. Supervisory issues should be presented succinctly and clearly. In all cases, the types of actions to be taken by the directors and management to address these problems should be specifically noted.

The definitions of MRIAs and MRAs, or references to the guidance defining MRIAs and MRAs, should be included as a footnote on this page. When issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners should not criticize an institution for a "violation" of supervisory guidance (as supervisory guidance is not legally binding).[17] When appropriate, examiners may reference (including in writing) supervisory guidance (such as interagency statements, advisories, bulletins, and policy statements) to provide examples of safe-and-sound conduct, appropriate risk-management practices, and other approaches to addressing compliance with laws or regulations.

This section should include newly identified MRIAs and/or MRAs, as well as the status of all prior MRIAs/MRAs that were either opened at the beginning of the examination cycle or have been issued in previous supervisory cycles. A detailed assessment of each prior MRIA or MRA is not required, however, examiners should reference previously issued reports where supervisory issues are discussed in greater detail.

In terms of organizing the findings in this section, examiners generally should list MRIAs and MRAs under separate subheadings. To convey the status of all findings that were open at the start of the supervisory cycle as well as findings opened during the supervisory cycle, examiners should include a table that provides the following information:

- The type of finding (MRIA/MRA) as well as the exact title of the finding that was previously communicated under separate cover.
- The entity of the institution to which the finding applies (typically, this would be the bank, but could be a subsidiary of the bank).
- The date which the finding was issued.
- The status of the issue.
- The expected timeline for completion.

Table 3 is a sample table to include in the Supervisory Issues section of the report. Examiners should explain the how the information is organized in the table (e.g., the severity of the finding, or date the finding was issued).

Compliance with Enforcement Action

The Compliance with Enforcement Actions section is optional. However, the section is *mandatory* if the institution is under a formal or informal enforcement action. If the compliance with enforcement action assessment was completed under separate cover, a concise paragraph describing overall compliance should be completed in the examination report and reference the initial correspondence for additional information. If not communicated under separate cover, this section should include a concise paragraph of the overall compliance with enforcement action. Additionally, this section

16. SR-13-13/CA-13-10, "Supervisory Considerations for the Communication of Supervisory Findings."

17. 12 CFR pt. 262, Appendix A.

Table 3. Summary of supervisory issues

Supervisory issue	Entity	Date issued	Status	Expected timeline for completion or closed date
Example text: BSA MRA — Customer Due Diligence	*Bank*	*May 6, 2019*	*Closed*	*November 30, 2020*
Example text: BSA MRIA — Higher-Risk Customer Monitoring	*Bank*	*May 6, 2019*	*Open*	*December 31, 2020*

should include all provisions of the enforcement action and a status and concise description of compliance with each provision. Examiners should follow the format of the enforcement action for this section. Status options for overall compliance and each provision of the enforcement action are as follows: in process, partial compliance, full compliance, noncompliance.

Management and Risk Management

This section is *mandatory*. Examiners should provide the management rating under the UFIRS as well as the Federal Reserve's risk-management rating.[18] Each component should include a concise paragraph to support the rating assigned. The Management assessment also should include commentary on the composition and qualifications of the bank's board and senior management. Examiners may also provide an assessment of the bank's governance structure in this section. Furthermore, examiners should discuss the risk factors and the adequacy of risk management associated with the risk levels and risk trends as well as the impact of specialty areas on relevant risk areas.

Financial Condition

This section is *mandatory*. This section communicates the ratings for each financial ratings (CAELS) components—Capital adequacy, Asset quality, Earnings, Liquidity, and Sensitivity to market risk. Subheadings are to be used to depict the ratings and describe analysis of the individual components. For each financial ratings component, examiners should include a concise paragraph to support each component rating assigned. Reserve Bank supervisory staff may add ratio tables, as necessary. If tables are used, financial information should not be repeated in the supporting paragraph.

Examiners have some flexibility in organizing the component ratings. However, more significant issues should be addressed at the beginning of this analysis. For example, in situations where any components are rated "3" or worse, or otherwise require emphasis, examiners may include information on the deficiencies in the introductory comment, with more detailed comments reserved for discussion under separate subheadings, or in the applicable supplemental report page.

Summary of Items Subject to Adverse Classification. Under the "Asset Quality" title of this section, examiners should convey a summary of items subject to adverse classification subsection, which summarizes items classified by the examiner as either substandard, doubtful, or loss as of the asset-quality review date of the examination.[19] The following table is *mandatory* (table 4).

18. See this manual's section on "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating," for specific guidance on rating the adequacy of risk-management processes and internal controls. See also SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion."

19. See SR-13-18, "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions."

Table 4. Summary of items subject to adverse classification

Organization	Substandard	Doubtful	Loss	Total
Parent				
Bank subsidiaries				
Nonbank subsidiaries				
Totals at current event *[Date]*				
Totals at previous event *[Date]*				
Totals at previous event *[Date]*				

Information Technology Assessment

The inclusion of an information technology assessment section is optional. This section is *mandatory* if the information technology assessment was completed and URSIT ratings were assigned during the examination or roll-up event.[20] The supporting rationale for the assigned URSIT ratings should be included. The examiner's conclusions should also be reflected in the Financial Condition or the Management and Risk Management sections of the report, as appropriate. Any significant supervisory concerns should be reflected in the Supervisory Issues section.

If the information technology assessment was completed under separate cover, a concise summary paragraph should be completed under Additional Supervisory Assessments section, which is described below.

Fiduciary Activities Assessment

The Fiduciary Activities Assessment section is optional. The section is *mandatory*, however, if a fiduciary activities assessment was completed during the roll-up event and a trust (UITRS) or transfer-agent rating was assigned.[21] The supporting rationale for any ratings assigned should be included. Conclusions should also be reflected in the Analysis of Financial Factors or the Management/Risk Management sections of the report, as appropriate. Significant supervisory concerns should be reflected in the Supervisory Issues section.

If the fiduciary activities assessment was completed under separate cover, a concise paragraph should be completed under Additional Supervisory Assessments section below. Exclude this section on years where fiduciary activities were not examined.

Consumer Compliance Assessment

This section is *mandatory*. This section is typically provided by Federal Reserve examiners in consumer affairs. Safety and soundness examiners should include high level supervisory conclusions, provided the consumer compliance assessment was conducted during the supervisory cycle. While this section is typically brief, examiners should include additional information, particularly if the bank's consumer compliance deficiencies compromise the safety and soundness of the bank or impact the adequacy of risk management. More information about the Federal Reserve's consumer compliance supervision program can be found in the *Consumer Compliance Handbook*.

Additional Supervisory Assessments

This section is *mandatory*. The information technology assessment and fiduciary activities assessment should be included in this section if the examination was performed and issued under separate cover during the supervisory cycle. The assessments of each area should be included in the text. Examiners should limit assessment descriptions for each area to a concise paragraph. In situations where areas require emphasis, examiners may include information on the deficiencies into the introductory comment, with more detailed comments reserved for discussion under separate subheadings, or in the applicable

20. See SR-99-8, "Uniform Rating System for Information Technology," and 64 Fed. Reg. 3109 (January 20, 1999) for more information.

21. See SR-98-37, "Uniform Interagency Trust Rating System," and 63 Fed. Reg. 54,704 (October 13, 1998) for more information.

supplemental report page. Discussion in this section should complement previous comments made in this report without being redundant.

Bank Secrecy Act/Anti-Money-Laundering Compliance Program. This subsection is *mandatory*. This subsection should describe the outcome of the BSA and AML compliance assessment from the examination or roll-up event. If the BSA/AML assessment was completed under separate cover, a concise paragraph should be included in this subsection describing the outcome or conclusions of the assessment. Conclusions should also be reflected in the Analysis of Financial Factors or the Management/ Risk Management sections of the report, as appropriate. Significant supervisory concerns should be reflected in the Supervisory Issues section.

Audit Program. This subsection is *mandatory* if an audit assessment was performed during the annual supervisory cycle. If the audit assessment was not performed during the supervisory cycle, examiners should comment on the bank's audit program in the "Management/Risk Management" section.

Other Matters. This subsection is optional and should only be included if matters of supervisory importance are not described elsewhere in the report. Discuss also significant matters mentioned elsewhere that require further explanation, such as the type, scope, and volume of any new activity in which the organization is engaged. If issues or concerns are noted, examiners should provide comments on specific areas, such as nontraditional banking activities, affiliate relationships, and significant litigation.

Signature of Directors

This section is *mandatory*. This section should indicate that the signature page should be attached to the report of examination and be retained at the bank. The signature of committee members will suffice only if the committee includes outside directors and a resolution has been passed by the full board delegating the review to such committee.

Expectations for the Completion of the Report of Examination

Standards for completing examination and inspection reports for RBOs are outlined in SR-17-12, "Timing Expectations for the Completion of Safety-and-Soundness Examination and Inspection Reports for Regional Banking Organizations." SR-17-12 applies to the completion of safety-and-soundness examination and inspection reports issued by the Federal Reserve for SMBs, BHCs, and their subsidiary Edge Act and agreement corporations, and SLHCs.[22]

Federal Reserve supervisory staff should complete and send the report of examination or inspection to the institution within the following timeframes:

- 90 calendar days from the start date for all reports issued to noncomplex holding companies;[23] and,
- 100 calendar days from the start date for all reports issued to SMBs, complex holding companies, and their nonbank and Edge Act subsidiaries.

In cases when reports are subject to statutory requirements for review by the CFPB, Reserve Banks may add up to 30 calendar days to the above timeframes.[24] Reserve Banks may exceed the timing requirements included in this letter at the discretion of Reserve Bank senior management; however, deviations from these standards are expected to be rare, and should be appropriately documented in workpapers. At the discretion of senior Reserve Bank management, additional exemptions from these timeframe guidelines may be considered for Federal Reserve led examinations that are conducted jointly or concurrently with another insured depository institution regulator.

22. Examples of safety-and-soundness examination and inspection reports include, but are not limited to, full-scope examination and inspection reports, target letters, roll-up examination and inspection letters, and specialty examination reports.

23. The start date is the date that Reserve Bank examiners and supervisory staff commence the commercial examination and inspection work, either off site or on site, excluding pre-exam visitations and examination preparation.

24. See sections 1022, 1024, and 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. For more information on the coordination of supervisory activities with the CFPB, see also the "Memorandum of Understanding on Supervisory Coordination" attached to the June 4, 2012 joint press release.

The Federal Reserve is committed to ensuring timely communication of supervisory findings. As part of each Reserve Bank's continuous supervision process, Reserve Banks should maintain open communication with institution management particularly during examinations and inspections. Open communication allows an opportunity for the institution's management to respond to preliminary supervisory findings prior to a Reserve Bank finalizing such findings.

SUMMARY AND PORTFOLIO TRANSITIONING

The Federal Reserve conducts tailored, risk-focused safety-and-soundness supervision of SMBs commensurate with their size and risk profile. As firms in the CBO and RBO portfolios grow, merge, or enter into new markets or activities, supervisors pay close attention to ensuring that risk-management processes keep pace with their complexity and risk.

The supervision of community SMBs is primarily driven by statutory mandates, and the Federal Reserve conducts a full-scope examination each supervisory cycle. Because regional SMBs are larger and more complex than community banks, there are several key differences in the Federal Reserve's supervisory approach for RBOs versus that of community banks. Regional SMBs are supervised under a continuous supervisory approach that relies on information extracted from continuous monitoring and several targeted supervisory events, which are summarized in an annual roll-up report. The level of communication between bank management and the Reserve Bank is intensified, which necessitates the assignment of a dedicated CPC for a regional SMB.

While not an exhaustive list, several regulations apply to regional SMBs and regional holding companies that do not apply to community banks in the same way:

- Regulation II (12 CFR pt. 235), "Debit Card Interchange Fees and Routing"[25]
- Regulation VV (12 CFR pt. 248) "Proprietary Trading and Certain Interests in and Relationships with Covered Funds" [26]
- Risk committee requirements of the Board's Regulation YY (12 CFR 252 subpart C)[27]
- Coordinated supervisory efforts with the CFPB[28]

As RBOs grow in size and complexity, the Federal Reserve categorizes certain firms as large and foreign banking organizations (LFBOs). LFBOs generally include U.S. firms with assets of $100 billion or more and foreign banking organizations with combined U.S. assets of $100 billion or more.[29] However, there are other considerations when assigning firms to the LFBO and other supervisory portfolios. Supervisory processes and procedures at RBOs and LCBOs are different. The Federal Reserve assigns dedicated supervisory teams to LFBOs. The size of the Federal Reserve supervisory team varies depending on the size, complexity, and risk profile of the firm as well as the level of assistance from the Reserve Bank's risk experts. Another key difference in the supervisory approach of LFBOs is the use of horizontal or multi-firm reviews. Horizontal reviews are a core component of the LFBO oversight program and are conducted based on an assessment of high-risk topics. While the supervision of SMBs is still relevant and important, the supervisory focus at LFBOs generally is at the consolidated holding company.

There are numerous supervisory policies, regulations, and reporting requirements that apply to LFBOs, which do not apply to RBOs. For example, there is a unique rating system for large financial institutions, which is composed of three components (1) Capital Planning and Positions; (2) Liquidity Risk Management and Positions; and (3) Governance and Controls.[30]

25. See the Regulation II compliance guide for more information.

26. The 2018 enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act modified the scope of the statutory definition of "banking entity" in section 13 of the Bank Holding Company Act (also referred to as the Volcker Rule) to exclude certain community banks and their affiliates, and in 2019, the regulations implementing the Volcker Rule were updated to reflect the statutory change. See 84 Fed. Reg. 35,008 (July 22, 2019).

27. Applies to BHCs with $50 billion or more in total consolidated assets.

28. Section 1025 of the Dodd-Frank Act requires that the CFPB and the prudential regulators, including the Board of Governors of the Federal Reserve System, coordinate important aspects of their supervision of insured depository institutions with more than $10 billion in assets and their affiliates.

29. See the Board's website for more information.

30. See SR-19-3/CA19-2, "Large Financial Institution (LFI) Rating System."

See the BHCSM section entitled, "Large Financial Institution Rating System," for more information.

Further, there are additional legal requirements for SMBs and holding companies that are in the LFBO portfolio. Below are some key examples:

- Capital plan rules for BHCs and SLHCs, which are outlined in Regulation Y (12 CFR 225.8) and Regulation LL (12 CFR 238.170).
- Enhanced prudential standards, which include liquidity requirements and capital stress testing requirements for BHCs (including U.S. intermediate holding companies of foreign banking organizations) and covered SLHCs, as described in Regulation YY (12 CFR pt. 252) and Regulation LL (12 CFR pt. 238),
- Liquidity coverage ratio (LCR) requirement and net stable funding ratio (NSFR) requirement for certain large firms on a consolidated basis as described in Regulation WW (12 CFR pt. 249)

The capital and liquidity requirements that are applicable for LFBOs result in additional regulatory reporting requirements. For example,

- FR 2052a, "Complex Institution Liquidity Monitoring Report" is filed by banking organizations subject to Category I, II, III, or IV standards under the Board's Regulation YY and Regulation LL. The 2052a collects quantitative information on selected assets, liabilities, funding activities, and contingent liabilities on a consolidated basis and by material entity subsidiary.
- FR Y-14A, "Capital Assessments and Stress Testing" report collects detailed data on BHCs', SLHCs', and intermediate holding companies' quantitative projections of balance sheet assets and liabilities, income, losses, and capital across a range of macroeconomic scenarios and qualitative information on methodologies used to develop internal projections of capital across scenarios. The data are used to assess the capital adequacy of large firms and inform the Federal Reserve's operational decision making as it continues to implement the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

Prior to a firm's transition to another Federal Reserve supervisory portfolio, Reserve Bank staff will meet with bank management to explain any differences in the supervisory approach. More information about the supervision of LFBOs is in the BHCSM.

Important aspects of the Federal Reserve's supervision programs are the assessment and evaluation of supervisory practices across groups of organizations with similar characteristics and risk profiles. The Federal Reserve organizes its supervisory programs by asset size of institutions, complexity, and activities.

State member banks, the holding companies of which are subject to Category I standards under the Federal Reserve Board's tailoring framework, are supervised as part of the Federal Reserve's Large Institution Supervision Coordinating Committee (LISCC) supervisory portfolio.[1]

For information on the supervision of LISCC firms, see

- *Large Institution Supervision Coordinating Committee Program Manual*, which sets forth key concepts related to the supervisory oversight structure, process, ratings framework, and communication methods directly related to LISCC firms.

For more information on the firms in the LISCC supervisory program, see

- SR-20-30, "Financial Institutions Subject to the LISCC Supervisory Program," and
- The Board's website for the list of firms subject to the LISCC supervisory program.

For more comprehensive information on supervisory practices, processes, and guidance, see relevant sections in this manual as well as the *Bank Holding Company Supervision Manual.*

1. For more information on the tailoring framework, see the Board's Regulation YY (12 CFR pt. 252).

INTRODUCTION

This section provides a brief overview of the Federal Reserve's policies, practices, and procedures relating to the examination of domestic and international banking activities of state-chartered commercial banks that are members of the Federal Reserve (state member banks or SMBs). The Federal Reserve also has certain supervisory and oversight responsibilities in other areas of banking, both domestic and international, for which it has developed specialized examination procedures, conducts on-site examinations, and generally completes separate examination reports.[1] These other areas of banking, such as information technology, Bank Secrecy Act (BSA) and anti-money-laundering (AML) compliance, and consumer compliance are not covered in depth in this manual. Federal Reserve policies and examination procedures relating to each of these areas are covered in either separate manuals, such as the *Federal Financial Institution Examination Council (FFIEC) Information Technology Examination Handbook*, *FFIEC BSA/AML Examination Manual*, and the *Consumer Compliance Handbook*, or supervisory letters (SR letters) issued by the Federal Reserve. Table 1 at the end of this section provides a list of key guidance references related to the examination of entities supervised by the Federal Reserve.

HOLDING COMPANIES

The Federal Reserve has the responsibility for supervising bank holding companies (BHCs) and savings and loan holding companies (SLHCs). These organizations control commercial banks and thrifts that hold most of the insured commercial banking assets in the United States. Most BHCs and SLHCs are subject to an examination or inspection by Federal Reserve examiners.

Since 2004, the Federal Reserve has used the "RFI/C(D)" rating system (RFI rating system) to communicate its supervisory assessment of BHCs regardless of their asset size, complexity, or systemic importance. In 2018, the Board adopted the RFI rating system for non-insurance and noncommercial SLHCs with less than $100 billion in total consolidated assets.[2] At the same time, the Board also adopted a rating system for BHCs and non-insurance and non-commercial SLHCs with total consolidated assets of $100 billion or more (referred to as the LFI rating system).[3] The LFI rating system also applies to U.S. intermediate holding companies of foreign banking organizations with combined U.S. assets of $50 billion or more established pursuant to the Federal Reserve's Regulation YY.

SUPERVISED INSURANCE ORGANIZATIONS

Certain holding companies are considered "supervised insurance organizations" (SIO), which have a unique supervisory framework. An SIO is a depository institution holding company that is an insurance underwriting company, that has over 25 percent of its consolidated assets held by insurance underwriting subsidiaries, or that has been otherwise designated as a supervised insurance organization by Federal Reserve staff. The supervisory framework for an SIO consists of the following:

- a risk-based approach to supervisory expectations, assigning supervisory resources, and conducting supervisory activities;
- a unique supervisory ratings system; and
- reliance, to the fullest extent possible, on the work performed by other relevant supervisors, including the state insurance regulators.

For more information see SR-22-8, "Framework for the Supervision of Insurance Organizations."

1. The Federal Reserve generally refers to supervisory activities of holding companies as inspections, rather than examinations.

2. See SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 billion," and SR-13-21, "Inspection Frequency and Scope Expectations for Bank Holding Companies and Savings and Loan Holding Companies that Are Community Banking Organizations," for more information on the inspection scope and frequency of holding companies with less than $100 billion in assets.

3. See SR-19-3/CA-19-2, "Large Financial Institution (LFI) Rating System."

INTERNATIONAL

Overseas Operations of U.S. Banking Organizations

The Federal Reserve has broad discretionary powers to regulate the foreign activities of member banks and BHCs so that, in financing U.S. trade and investments abroad, these U.S. banking organizations can be competitive with institutions of the host country without compromising the safety and soundness of their U.S. operations.[4] Under provisions of the Federal Reserve Act and the Board's Regulation K, SMBs may establish branches in foreign countries subject to, in most cases, the Board's prior approval. Furthermore, Section 25 of the Federal Reserve Act permits the Board to order special examinations of foreign branches, banks, or corporations as it may deem best. However, the Federal Reserve's examinations of a SMB's overseas operations and activities are usually conducted at the head office in the United States, where the ultimate responsibility for the overseas activities and facilities may lie. To adequately supervise international operations, examiners and supervisory staff should continuously monitor the bank's international activities to understand and assess the extent of its international strategy, trends, operations, and legal-entity structure as well as related governance, risk management, and internal controls.

Edge Act and Agreement Corporations

Under Sections 25 and 25A of the Federal Reserve Act, Edge Act and agreement corporations may engage in international banking and foreign financial transactions, and the Federal Reserve is responsible for conducting examinations of these entities and their branches. (See Regulation K, 12 CFR 211.) Edge corporations are chartered by the Board to conduct an international banking business. Agreement corporations are state-chartered companies that enter into an agreement with the Board to limit their operations to international banking. These corporations, which are usually subsidiaries of SMBs, provide their owner organizations with additional powers in two areas: (1) they may conduct a deposit and loan business in states other than that of the parent, provided that the business is strictly related to international transactions and (2) they have somewhat broader foreign-investment powers than SMBs, being able to invest in foreign financial organizations, such as finance companies and leasing companies, as well as in foreign banks.

U.S. Activities of Foreign Banking Organizations

Foreign entities have operations in the United States and are a significant element in the U.S. banking system. The Federal Reserve has significant authority over foreign banking organizations (FBOs). Its role was enhanced by the Foreign Bank Supervision Enhancement Act of 1991 (FBSEA). The Federal Reserve has broad oversight authority for the supervision and regulation of FBOs that engage in banking in the United States through branches, agencies, commercial lending companies, and subsidiary banks. In fulfilling this responsibility, the Federal Reserve conducts its own examinations and relies, to the fullest extent possible, on the reports of examination made by the primary federal or state supervisor of the branch or agency of the foreign bank.

Section 10(d) of the Federal Deposit Insurance Act (FDI Act) generally requires the appropriate federal banking agency for an insured depository institution (IDI) to conduct a full-scope, on-site examination at least once every 12 months, but permits a longer examination cycle—at least once every 18 months—for IDIs that meet certain criteria, including the requirement that the IDI must have total assets below a specified amount. Section 210 of the Economic Growth, Regulatory Relief, and Consumer Protection Act amended section 10(d) of the FDI Act to increase from $1 billion to $3 billion the total asset threshold below which an IDI may qualify for the 18-month examination cycle.[5]

Consistent with the requirements in Regulation H, Regulation K states that a U.S. branch or agency of a foreign bank with less than $3 billion in total assets may be eligible for an 18-month on-site examination cycle if it re-

4. For more information, see the "International Banking Activities," section in the *Bank Holding Company Supervision Manual*.

5. For more information, see the Board's Regulation K (12 CFR 211.26(c)).

ceived, at its most recent examination, a composite condition rating of "1" or "2" under the supervisory rating system (see SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations")[6] and if it satisfies the following criteria:

1) Either: (a) the foreign bank's most recently reported capital adequacy position consists of, or is equivalent to, tier 1 and total risk-based capital ratios of at least 6 percent and 10 percent, respectively, on a consolidated basis; *or* (b) the branch or agency has maintained on a daily basis, over the past three quarters, eligible assets in an amount not less than 108 percent of the preceding quarter's average third-party liabilities (determined consistent with applicable federal and state law) and sufficient liquidity is currently available to meet its obligations to third parties;
2) The branch or agency is not subject to a formal enforcement action or order by the Board, Federal Deposit Insurance Corporation, or Office of the Comptroller of the Currency; and
3) The branch or agency has not experienced a change in control during the preceding 12-month period in which a full-scope, on-site examination would have been required but for the 18-month examination cycle eligibility provision.[7]

The Federal Reserve may consider additional factors when determining the eligibility of a U.S. branch or agency of a foreign bank for an 18-month examination cycle, including whether (1) any of the individual components of the ROCA rating system of a branch or agency of a foreign bank is rated "3" or worse; (2) the results of any off-site surveillance indicate a deterioration in the condition of the branch or agency; (3) the size, relative importance, and role of a particular branch or agency in the context of the foreign bank's entire U.S. operations otherwise necessitate an annual examination; and (4) the condition of the foreign bank gives rise to such a need.[8] Refer to SR-18-7, "Updates to the Expanded Examination Cycle for Certain State Member Banks and U.S. Branches and Agencies of Foreign Banking Organizations."

The FBSEA also requires Federal Reserve approval for establishment of new FBO offices in the United States, and it gives the Federal Reserve the authority to terminate such offices.

Representative Offices of FBOs

U.S. representative offices of FBOs engage in diverse activities ranging from liaison, marketing, and research functions to operational activities such as loan production, administrative, and certain trading functions. Responsible Reserve Banks should incorporate the supervision of representative offices of FBOs into the overall supervisory strategy for the entire U.S. operations of the FBO. The extent of activities at the U.S. representative office directly affects of the level of supervision by the responsible Reserve Bank. For more information, see SR-19-15, "Revised Examination Guidelines for Representative Offices of Foreign Banks."

INFORMATION TECHNOLOGY ACTIVITIES

The Federal Reserve is responsible for conducting information technology (IT) examinations of SMBs, FBOs, and Edge Act corporations. Section 3 of the Bank Service Corporation Act (12 USC 1863, re-designated as the Bank Service Company Act) generally authorizes bank service companies to perform significant clerical, bookkeeping, or accounting functions, such as demand-deposit accounting and loan processing. Section 7 of the Bank Service Company Act (12 USC 1867) empowers the appropriate federal regulatory agency to examine banking services and operations regardless of whether these services are performed on or off the premises of a particular financial institution. When a financial institution contracts with an external company to provide data processing services, the third-party technology service provider's activities that pertain to financial institutions are subject to examination. Larger companies that operate in more than one regulatory district or region are examined pursuant to the Significant Service Provider examination program. IT ex-

6. SR-00-14 describes the ROCA rating system. The ROCA system represents a rating of the risk management, operational controls, compliance, and asset quality of an FBO's U.S. activities.
7. 12 CFR 211.26(c).
8. 12 CFR 211.26(c)(2)(ii).

aminations are based on a risk evaluation of four critical components: Audit, Management, Development and Acquisition, and Support and Delivery. Examiners evaluate the functions identified within each component to assess the institution's ability to identify, measure, monitor and control information technology risks.

TRUST DEPARTMENTS AND TRANSFER AGENT ACTIVITIES

The Federal Reserve examines trust departments of SMBs, state-chartered trust companies that are members of the Federal Reserve System, and certain nondepository trust company subsidiaries of holding companies. The Federal Reserve also has a program of examinations for those trust companies not supervised by any other federal banking agency. In addition, examinations are conducted of Edge Act corporations that conduct foreign trust or fiduciary services, in accordance with Regulation K (12 CFR 211). These examinations determine whether the trust functions are conducted in accordance with applicable fiduciary principles and with other appropriate laws and regulations. The federal banking agencies originally adopted the Uniform Interagency Trust Rating System (UITRS) in 1978 to evaluate the fiduciary activities of financial institutions on a uniform basis. The FFIEC issued modifications to the UITRS in 1998, in part, to align the UITRS rating definitions with existing safety-and-soundness ratings definitions and to emphasize the importance of sound risk-management processes.

To engage in providing trust or fiduciary services, a bank must have proper authorization under state or federal law. Under the laws of most states, this requires a specific approval of the state financial supervision agency. Similarly, pursuant to the Board's Regulation H (12 CFR 208.3(d)(2)), the Board's permission must be obtained before changing the general character of a bank's business.

Transfer agents record changes of owners of a security, maintain the issuer's security holder records, cancel and issue certificates, and distribute dividends. An SMB, a subsidiary thereof or a holding company conducting transfer agent activities, is required to register as a transfer agent with the Federal Reserve. Federal Reserve examiners conduct separate examinations of, and complete separate reports for, the transfer-agency activities of those SMBs and BHCs that are registered with the Federal Reserve as transfer agents.

MUNICIPAL SECURITIES DEALERS, GOVERNMENT SECURITIES DEALERS, AND CLEARING AGENCIES

As a result of the Securities Act Amendments of 1975, the Board is responsible for supervising SMBs and BHCs that act as municipal securities dealers or clearing agencies. Federal Reserve examiners conduct separate examinations of and complete separate reports for both of these activities. A bank, a separate department or division of a bank, or a holding company is required to register as a municipal securities dealer if it deals in municipal securities for its own account other than in a fiduciary capacity.

The Government Securities Act of 1986 (GSA), as amended, gives the Federal Reserve responsibility for examining the government securities activities of an SMB, foreign bank, state branch or state agency of a foreign bank, or commercial lending company owned or controlled by an FBO, or Edge Act or agreement corporation. The GSA requires all government securities brokers or dealers to register with the U.S. Securities and Exchange Commission. Government securities brokers and dealers receive specialized examinations to determine compliance with the GSA. For banks that have a lower level of government securities activities, compliance with the GSA is determined as part of the commercial examination.

The responsible Federal Reserve staff conducting the examination need to fully consider their supervisory responsibilities under the GSA in formulating their supervisory plans and conducting risk-focused examinations. In this regard, two key factors should be considered concerning government securities custodial activities. First, all depository institutions that hold government securities for customers, including securities under repurchase agreements, are subject to the U.S. Department of Treasury's GSA custody rules. Second, certain financial institutions that are exempt from the definition of a government securities broker or dealer are, nevertheless, subject to the U.S. Department of Treasury's government securities broker or dealer custody rules when they engage in hold-in-custody repurchase agreements. Under such agreements, the financial institution retains custody of securities that are the subject of a repurchase agreement between the financial institution and a counterparty.[9] These issues are more fully described in the examination procedures pertaining to government securities activities.

Reserve Bank staff are to separately report to Board staff only the results of reviews of government securities broker-dealer activities (and such broker-dealer's related custodial activities). See SR-06-8, "Reports of Examinations of Government Securities Activities," and its attachment. When preparing these reports, Reserve Banks have the option of either using the Summary Report of Examination of Government Securities Broker-Dealer Activities and Custodial Activities (GSB-D report) or forwarding a copy of the relevant section of the examination report that contains the same information as required in the GSB-D report.

A clearing agency acts as a custodian of securities for the settlement of securities transactions by bookkeeping entries. Separate reporting on the GSB-D form is not required for a government securities custodian that engages in hold-in-custody repurchase agreements but which is otherwise exempt from filing notice as a government securities broker or dealer. See the U.S. Department of Treasury's regulation on Protection of Customer Securities and Balances (17 CFR 403.5(a) and (d)), and SR-93-40, "Department of the Treasury Interpretation Regarding Allocation of Securities to Customer Accounts in Hold-in-Custody Repurchase Transactions."

9. See the U.S. Department of Treasury's regulation on Custodial Holdings of Government Securities by Depository Institutions, which governs holdings of government securities for customers, except those held in a fiduciary capacity (17 CFR 450.3).

CONSUMER EXAMINATIONS

Some banking laws, such as the Truth in Lending Act and the Truth in Savings Act, require banks to disclose information that helps consumers evaluate product options open to them. Other laws (for example, the Community Reinvestment Act and the Equal Credit Opportunity Act) require banks to help meet the credit needs in their communities and promote the availability of credit to all creditworthy applicants. Finally, laws such as the Fair Credit Reporting Act and the Fair Debt Collection Act provide consumer safeguards for the extension, collection, and reporting of consumer credit. At the Federal Reserve, specialized examiners conduct examinations to determine banks' compliance with these laws and their implementing regulations.

In 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act), which established the Consumer Financial Protection Bureau (CFPB). Under the Dodd-Frank Act, the CFPB has authority to examine IDIs and insured credit unions with consolidated assets of more than $10 billion and their affiliates, to assess compliance with the requirements of 18 enumerated federal consumer financial laws, and to assess risks to consumers and financial markets from consumer financial products and services. The Federal Reserve has consumer compliance supervisory responsibility for (1) SMBs with consolidated assets of more than $10 billion for their compliance with consumer protection laws not specifically assigned to the CFPB, and (2) SMBs with consolidated assets of $10 billion or less for their compliance with all consumer protection laws. The Federal Reserve is also responsible for conducting Community Reinvestment Act examinations for SMBs, regardless of asset size.

Table 1. Other Types of Examinations and Relevant Guidance

Examination Type or Examined Entity	*Relevant Guidance*
Holding Companies	• Federal Reserve's *Bank Holding Company Supervision Manual* • SR-19-4/CA-19-3, "Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100 Billion" • SR-19-3/CA-19-2, "Large Financial Institution (LFI) Rating System" • SR-13-21, "Inspection Frequency and Scope Expectations for Bank Holding Companies and Savings and Loan Holding Companies that Are Community Banking Organizations"
Supervised Insurance Organizations	• SR-22-8, "Framework for the Supervision of Insurance Organizations"
Overseas Operations of U.S. Banking Organizations	• Sections 1050.1 and 1050.2 of the *Bank Holding Company Supervision Manual* • SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations"
Edge Act and Agreement Corporations	• SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" • SR-90-21, "Rating System for International Examinations"
U.S. Activities of Foreign Banking Organizations	• SR-19-15, "Revised Examination Guidelines for Representative Offices of Foreign Banks" • SR-12-17/CA-12-14, "Consolidated Supervision Framework for Large Financial Institutions" • SR-08-9, "Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations" • SR-00-14, "Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations" • SR-96-36, "Guidance on Evaluating Activities Under the Responsibility of U.S. Branches, Agencies and Nonbank Subsidiaries of Foreign Banking Organizations (FBOs)"
Information Technology Examinations	• *FFIEC Information Technology Examination Handbook* • The Information Technology section of this manual • SR-00-3, "Information Technology Examination Frequency" • SR-99-8, "Uniform Rating System for Information Technology"

Examination Type or Examined Entity	*Relevant Guidance*
Trust Departments and Transfer Agent Activities	• The Fiduciary Activities section of this manual • SR-01-5, "Examination of Fiduciary Activities" • SR-98-37, "Uniform Interagency Trust Rating System" • SR-96-10, "Risk-Focused Fiduciary Examinations"
Municipal Securities Dealers Government Securities Dealers Clearing Agencies	• SR-06-8, "Reports of Examinations of Government Securities Activities" • SR-94-5, "Government Securities Act Amendments of 1993" • SR-93-40, "Department of the Treasury Interpretation Regarding Allocation of Securities to Customer Accounts in Hold-in-Custody Repurchase Transactions" • SR-90-1, "Examination of State Branches and Agencies of Foreign Banks for Compliance with Regulations Related to Government Securities Activities" • SR-88-26, "Examination Procedures Relating To Government Securities Activities" • SR-87-37, "Examination Procedures Relating to Government Securities Activities" • SR-86-40, "Revised Municipal Securities Dealer Examination Procedures and Report Forms"
Consumer Examinations	• Federal Reserve's *Consumer Compliance Handbook*

GENERAL CONFLICT-OF-INTEREST RULES

Federal Reserve System (System) employees, including examiners, are subject to conflict-of-interest rules designed to ensure compliance with criminal statutory prohibitions as well as to avoid any actual or apparent conflicts that may affect the objectivity and integrity of bank examinations and supervisory activities.

The conflict-of-interest rules are set forth in the federal statutes, section 5 of the Federal Reserve Administrative Manual (FRAM), and in each Reserve Bank's uniform code of conduct. The FRAM is a compilation of current Federal Reserve System operating policies and procedures issued by the Board of Governors that provides comprehensive ethics-related guidelines pertaining to System supervisory staff such as

- recusal from certain supervisory matters,
- borrowing prohibitions,
- prohibiting political communications with insured depository institutions or their affiliates, and
- post-employment restrictions.

System employees are also prohibited from any actual or apparent misuse of their official positions, including

- using one's Federal Reserve position for private gain,
- giving preferential treatment to any person or institution,
- losing independence or impartiality, or
- making decisions outside of official channels.

EXAMINER BORROWING RESTRICTIONS

A bank examiner is prohibited from accepting a loan or gratuity from any bank that they examined (18 U.S.C. 213). This restriction may also be applicable to a loan obtained by a System employee who has been issued a special, temporary, or ad hoc examiner credential.

A bank examiner found in violation of the borrowing prohibition can be—

- fined, imprisoned for no more than one year, or both;
- further fined a sum equal to the money loaned or gratuity given; and
- disqualified from holding office as an examiner.

In addition to the federal criminal restrictions, FRAM 5-041 prohibits examiners from directly or indirectly borrowing from (including having a line of credit or a credit card issued by) an institution for which the Federal Reserve is the primary supervisor other than through certain credit cards or home mortgage loans. In its discretion, a Reserve Bank also may prohibit examiners from borrowing from any subsidiary of an in-District bank holding company if such borrowing would hinder the Reserve Bank's ability to carry out its supervisory responsibilities by limiting staffing resources.

POST-EMPLOYMENT RESTRICTIONS FOR "SENIOR EXAMINERS"

In 2005, the federal bank regulatory agencies[1] issued rules to implement the post-employment restriction of section 10(k) of the Federal Deposit Insurance Act (FDI Act) as amended by the Intelligence Reform and Terrorism Prevention Act of 2004 (see 12 U.S.C. 1820).[2]

Post-Employment Compensation Restriction

The restriction prohibits a System employee who served as a "senior examiner" for a depository institution or depository institution holding company for two or more months during the examiner's final 12 months of employment with a Reserve Bank from knowingly accepting compensation for service as an employee, an officer,

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

2. Pub. L. 108-458, 118 Stat. 3638, 3751–53 (December 17, 2004). See also 12 CFR pt. 264a as well as SR-21-13/CA-21-10, "Revised Special Post-Employment Restriction for Senior Examiners and Work Paper Reviews for Departing Examiners," and its attachments.

a director, or a consultant from that depository institution or holding company, or from certain related entities. This prohibition applies for one year after an examiner leaves System employment. SR-21-13/CA-21-10 summarizes how the restriction applies to "senior examiners" based on the legal entity of the supervised institution at which the individual served as a senior examiner.

Definition of "Senior Examiner"

For purposes of this rule, an officer or employee (employee) of the System is considered to be a "senior examiner" for a particular depository institution or depository institution holding company[3] if the individual meets all of the following critheria:

- The employee has been authorized by the Board to conduct examinations or inspections on behalf of the Board.
- The employee has been assigned *continuing, broad, and lead* responsibility for examining or inspecting that the depository institution or the depository institution's holding company.
- The employee's responsibilities for examining, inspecting, and supervising the depository institution or the depository institution's holding company—
  - represent a *substantial portion* of the officer's or employee's assigned responsibilities, and
  - require the employee to interact routinely with officers or employees of the depository institution or depository institution holding company.
- The depository institution or the depository institution's holding company to which the employee has been assigned is not considered to be a "community banking organization." (See the "Community Bank Supervision Process" section of this manual for more information.)

This rule applies only to an individual serving in a leadership role who is dedicated to supervising a *single* depository institution (or group of affiliated depository institutions) or the depository institution's holding company.[4] Specifically, the restriction applies to examiners serving in principal roles requiring meaningful engagement with an institution, such as senior supervisory officers (SSOs), deputy SSOs, enterprise risk officers (EROs),[5] central points of contact (CPCs), deputy CPCs, and supervisory team leaders.[6]

The rule does not cover an individual who

- is dedicated to supervising a single depository institution (or group of affiliated depository institutiosns) or depository institution's holding company, but does not have leadership responsibilities in conjunction with this role;
- serves in a leadership role for *multiple* unaffiliated depository institutions or depository institutions' holding companies at the same time; or
- performs only periodic, short-term examinations of a depository institution or a depository institution's holding company, dedicating less than two months in a year to that institution or only longer-term examinations related to specific, unplanned events (e.g., fraud investigations) outside the normal supervisory cycle.

Penalties for Violating "Senior Examiner" Restriction

The restriction applies to a covered individual for one year after the individual terminates their employment with the Reserve Bank. If an ex-

3. This is applicable to financial market utilities, and nonbank financial companies that are designated by the Financial Stability Oversight Council for supervision by the Federal Reserve, only to the extent that they are depository institutions or depository institution holding companies.

4. An employee may be considered a "senior examiner" for only one institution or group of affiliated institutions at a time.

5. SSOs, Deputy SSOs, and EROs are job titles used by the Federal Reserve Bank of New York for senior officers serving on dedicated teams for large financial institutions. For comparative purposes, the SSO job title is considered equivalent to the CPC job title, while the ERO job title is equivalent to the deputy SSO/CPC job title.

6. A supervisory team leader is defined as any Reserve Bank officer or employee who serves in a leadership role as part of a dedicated supervisory team. Examples of supervisory team leaders may include risk team leaders, business line team leaders, and the chief operating officers assigned to or supporting a dedicated supervisory team. As discussed in SR-21-13/CA-21-10, these titles should be treated solely as examples of roles that could be considered a senior examiner. The application of 12 CFR pt. 264a is determined based on the roles and responsibilities of individuals rather than their specific job title. Questions regarding applicability and interpretation of this guidance and 12 CFR pt. 264a should be directed to a Reserve Bank's conflicts-of-interest staff.

aminer violates the one-year restriction, the statute requires the appropriate federal banking agency to seek an order of removal and industry-wide employment prohibition for up to five years, a civil money penalty of up to $250,000, or both.[7]

ADMINISTRATIVE PROCEDURES FOR IMPLEMENTING THE "SENIOR EXAMINER" RESTRICTION AND ADDITIONAL GUIDELINES

Reserve Banks must adopt the specific procedures to ensure that the "senior examiner" rule is properly implemented. SR-21-13/CA-21-10 was issued to promote consistency across the Federal Reserve System in identifying examiners subject to the post-employment ethics restrictions of section 10(k) of the FDI Act. Reserve Bank staff should review SR-21-13/CA-21-10, as well as its attachments, for more information on implementing the post-employment restriction on senior examiners.

7. In special circumstances, the Chair of the Board of Governors may waive the restriction for the "senior examiner" of the Federal Reserve by certifying in writing that granting the individual a waiver of the restriction would not affect the integrity of the Federal Reserve's supervisory program.

INTRODUCTION

The Federal Reserve System (the System) deploys algorithms in regular monitoring to identify state member banks that (1) take on positions or pursue strategies that could lead to problem situations, (2) have a weak or declining financial condition, or (3) fail to comply with regulations. The surveillance systems rely on the Call Report, other regulatory reports, and examination data, as well as external data sources, to identify institutions exhibiting increased risk profiles, financial deterioration, or compliance shortfalls. The surveillance process promotes timely supervisory attention to these cases and directs examination resources to them.

System bank surveillance algorithms focus on many areas evaluated in the supervisory process, such as capital adequacy, liquidity, credit risk, market risk, and overall safety and soundness. In addition, screens flag banks engaging in new or complex activities. The algorithmic system's main components are the Outlier List, Watch List, State Member Bank Monitoring Screen, and Intercompany Transactions Exception List, as implemented in SR-15-16, "Enhancements to the Federal Reserve System's Surveillance Program," December 10, 2015, and described below. The surveillance information helps identify weak or deteriorating banks and those with changing risk profiles or deviations from supervisory expectations.

In addition to regular monitoring, supervisory staff also use surveillance results in pre-examination planning. Before an on-site review, the examiner will determine a bank's status on the System's Outlier List, Watch List, State Member Bank Monitoring Screen, and Intercompany Transactions Exception List. This information is useful in determining the type of examination to be performed (full or targeted), its scope and intensity, and the staff resources needed. The surveillance results are used to identify bank activities that may warrant a higher degree of review or focus during an on-site examination. In this manner, surveillance information helps examiners and other supervisory staff plan and schedule more forward-looking, risk-focused examinations.

Bank Surveillance Program activities generally consist of the following three phases:

1. In the first phase, data are processed by the algorithms, ranging from simple rules to financial models and machine learning results. When the algorithms detect departures from expected patterns involving banks, the results are transmitted via Performance Report Information and Surveillance Monitoring (PRISM), a web application available to Federal Reserve examiners and other supervisory staff for interactive data analysis.
2. The second phase begins as supervisory staff use additional tools and data to solidify the initial impressions presented by first-phase surveillance results. Key examples are the Focus Report—a web application available to Federal Reserve examiners and other supervisory staff for interactive risk assessment—and the Uniform Bank Performance Report. In addition, aggregate data views and reports of financial condition at the supervisory portfolio and industry levels can help place a particular bank's status in context.
3. The third phase involves the development of supervisory responses to the information generated in the first two steps. A primary goal is to focus supervisory resources on excessive risk-taking, the risk of emerging financial difficulties, and potential compliance shortcomings. Possible actions include intensification of an on-site review or acceleration of its scheduling. When problems are identified, follow-up by examiners promotes correction and resolution. By also identifying low-risk situations, the Bank Surveillance Program promotes the application of more streamlined supervisory approaches for such cases.

OUTLIER LIST

An Outlier List highlights state member banks with elevated risk-taking and identifies those with expanded or new areas of risk-taking. It is supported by "Outlier Metrics" in the form of algorithms generating risk classifications of low, moderate, or high for individual risk and performance dimensions. The Outlier List includes banks categorized as high risk within at least one risk or performance dimension. The risk identification algorithms can be based on a broad range of approaches and may evolve over time.

Examiners and other supervisory staff should use the Outlier List to monitor risk-taking and promote adequate risk management and mitigation, with the goal of bolstering banks' capacity to prevent or buffer financial losses. However, no regular write-up or documentation requirement is tied to the Outlier List.

The Outlier Metrics also assist examiners and other supervisory staff in determining the scope of a safety-and-soundness examination. The Outlier Metrics' role in pre-examination planning is particularly strong at community and regional state member banks, where a subset of the Outlier Metrics is implemented as in SR-19-9, "Bank Exams Tailored to Risk (BETR)," June 3, 2019. BETR's Outlier Metrics combine with examiner judgment to classify the levels of risk at a state member bank within individual risk dimensions, such as credit, liquidity, and operational risk. The bank's examination is then tailored to reflect the levels of risk present and minimize regulatory burden for the bank.

BETR's primary objectives are the following:

1. Identify a state member bank's activities that are low risk and apply appropriately streamlined examination work programs to those areas, thereby conserving supervisory staff resources.
2. Identify a state member bank's high-risk activities and target them for enhanced supervisory attention, thereby directing supervisory resources to where they are most needed.
3. For the remaining moderate-risk activities, implement examination work programs of average intensity.

BETR's Outlier Metrics gauge the potential for a state member bank to experience adverse outcomes, such as highly unfavorable financial trends, significant performance shortfalls, severe losses, or supervisory rating downgrades, over a 12- to 24-month timeframe, and under unfavorable market conditions. As such, the metrics assist examiners in classifying the levels of risk related to a bank's activities.

For each risk dimension considered by BETR, the Outlier Metrics classify the corresponding activity of a state member bank. Low-risk activities pose the least potential for adverse outcomes to a bank, while high-risk activities entail the greatest chance of unfavorable results. The following definitions generally apply:

- *High risk:* Under unfavorable market conditions, such activities often lead to adverse outcomes.
- *Moderate risk:* In unfavorable markets, these activities occasionally result in adverse outcomes.
- *Low risk:* The expected incidence of adverse outcomes is low, irrespective of market conditions.

The design features of the Outlier Metrics used in BETR are as follows:

1. *Data-driven:* The information content, or predictive capacity, of the metrics is confirmed via data analysis. This feature involves the estimation and back-testing of the metrics using data from previous banking cycles.
2. *Forward-looking:* The metrics gauge the risk posture of a state member bank and its susceptibility to severe losses or substantial underperformance. This feature is supported by estimating the relationship between risk indicators at a given point in time and bank performance a year or two later, particularly under unfavorable market conditions.
3. *Granular:* The metrics provide insight into individual risk dimensions. This feature is incorporated by developing the metrics separately for each risk dimension considered.

Outlier Metrics provide examiners with a data-driven starting point for determining the scope of a state member bank's examination. In cases where examiners are aware of factors indicating that an alternative risk classification for a particular risk dimension would be more appropriate, they should exercise supervisory judgment and adjust the risk tier during the scoping process. Examiners should then record their rationale in appropriate work papers and plan the examination work program accordingly.

BETR's Outlier Metrics should be used to allocate more examiner resources to review high-risk situations, while conserving resources in lower risk cases. The examiner should exercise prudent supervisory judgment and consider an institution's Outlier List status and all other applicable information, including the Watch List, State Member Bank Monitoring Screen, Intercompany Transactions Exception List, and previous examination results, when determining the scope and nature of the examination work required.

When the Outlier Metrics and other applicable information indicate a specific risk is high, the examiner generally should apply the fullest force of supervisory resources. Conversely, when the Outlier Metrics and other applicable information indicate a specific risk is moderate, and especially when risk is low, the examiner may be able to complete a smaller set of procedures. However, if during the course of an examination indications point to higher risk than anticipated or significant weaknesses in risk management, the examiner is expected to increase the examination's intensity or expand its scope, as needed.

WATCH LIST

The Watch List is a primary means for monitoring state member bank performance and condition between on-site examinations. It identifies the risk of emerging financial weaknesses among banks and includes all state member banks with composite safety-and-soundness ratings consistent with financial viability, but surveillance grades of "D" or "F," pointing to the possibility of deterioration in examination findings going forward.

To generate the surveillance grades, the Supervision and Regulation Statistical Assessment of Bank Risk (SR-SABR) early-warning model is applied to financial and supervisory information for each bank. The SR-SABR rating consists of the composite rating most recently assigned to a bank via the examination process, coupled with a surveillance letter grade (A, B, C, D, or F) reflecting the bank's estimated financial condition relative to others in the same rating class.[1]

SR-SABR ratings are designed for use both in monitoring and in determining the scope of an examination. An accompanying Schedule of Risk Factors (SRF) highlights specific indicators leading the model to flag a particular bank as strong or weak. Through ongoing monitoring, examiners and other supervisory staff review each state member bank on the Watch List to assess its financial condition and discern whether substantial deterioration is evident or impending. In such cases, they determine whether an examination or other supervisory initiative might be needed. The Watch List, much like the Outlier List and its metrics, can also be used in pre-examination planning to target potentially deteriorating situations for the most extensive reviews.

At times, Reserve Bank staff may need to produce supporting documentation to explain the reasons for a bank's placement on the Watch List and outline the appropriate supervisory response. For banks other than community banks, this type of information is often already contained in quarterly supervisory write-ups outside of the Watch List process. Separate surveillance write-ups are required for community banks on the Watch List when any of the following criteria are met:

1. The current SR-SABR rating is worse than the prior quarter; or
2. The SR-SABR rating is the same as the prior quarter, but the SRF identifies one or more new contributing factors; or
3. The most recent requirement for a write-up occurred four quarters earlier.

The assessments and conclusions comprising a write-up should be brief and supported by analysis. A Watch List write-up should

1. Summarize the factors leading to Watch List placement;
2. Describe any response from the bank to those factors;
3. Assess the likelihood of further financial deterioration;
4. Judge whether assigned safety-and-soundness ratings are accurate; and
5. Determine whether the timing of the next examination should be accelerated.

Corrective action associated with newly identified problems must be initiated promptly by Reserve Banks. Follow-up action may include correspondence or meetings with a bank's management or an on-site examination. Problem situations should be closely monitored by supervisory staff until they have been corrected or otherwise resolved.

1. In the model, banks with satisfactory composite ratings are grouped together into a single rating class. An SR-SABR grade of "A" denotes a bank with strong indicators relative to others in the same rating class, while an "F" indicates major weaknesses. Two grades are assigned to each bank, one reflecting the estimated probability of a downgrade to a worse rating class (Adverse Change grade) and another reflecting the estimated probability of critical undercapitalization or failure (Viability grade). The overall SR-SABR rating is based on the worse of the two grades.

STATE MEMBER BANK MONITORING SCREEN

The State Member Bank Monitoring Screen identifies complex activities, monitors compliance with regulations, and more generally can be used to detect novelties or departures from expected patterns. The monitoring screen identifies banks that have failed key screening criteria. The screening criteria are updated periodically and change over time. Examiners and other supervisory staff review State Member Bank Monitoring Screen results quarterly and follow up with supervisory initiatives when appropriate.

INTERCOMPANY TRANSACTIONS EXCEPTION LIST

The Intercompany Transactions Exception List helps track compliance with section 23A of the Federal Reserve Act;[2] it is a specialized monitoring process utilizing data from the FR Y-8, together with information from the Call Report.

For each depository institution possibly exceeding section 23A limits, supervisory staff perform the following: (1) follow up with the holding company submitting the FR Y-8 to verify the data are accurate; (2) if an error caused the exception, require an amended report; and (3) if the data are correct, and a depository institution appears to have had covered transactions exceeding section 23A limits, determine the nature and extent of the apparent violation. Reserve Bank staff produce a written review of their findings for each depository institution on the list. The review addresses any apparent violations or reporting errors, along with any corrective action taken.

2. See also the Board's Regulation W at 12 CFR 223.

1. To identify major changes in the risk posture of the bank between examinations.
2. To identify major changes in the financial condition of the bank between examinations.
3. To assist in determining the scope of the examination and the priority of work to be performed.
4. To check the validity of the data being reported by the bank.
5. To investigate areas where attention or an in-depth review is indicated.

1. Obtain any surveillance results, such as the Outlier List, Watch List, State Member Bank Monitoring Screen, and Intercompany Transactions Exception List, together with any other reports or analyses prepared by the Reserve Bank or Board, that have been generated for the bank.
2. Review the information obtained in step 1, and if necessary for clarification discuss those findings with surveillance staff.
3. Conduct a pre-examination analysis using the information from steps 1 and 2, together with the current Call Report, Uniform Bank Performance Report, prior examination report, and any other applicable information. This analysis should be considered when determining the scope of the examination and when making staffing decisions.
4. Follow up on any unusual aspects of the surveillance information, other reports and analyses, and newly obtained data.
5. Perform validity checks necessary to ensure the quality of reported data. This would include such normal examination procedures as validating Call Report information and confirming the accuracy and soundness of accounting practices.

INTRODUCTION

Workpapers are the written documentation of the procedures followed and the conclusions reached during the examination of a bank. Accordingly, they include, but are not necessarily limited to, examination procedures and verifications, memoranda, schedules, questionnaires, checklists, abstracts of bank documents and analyses prepared or obtained by examiners.

The definition of workpapers, their purpose, and their quality and organization are important because the workpapers as a whole should support the information and conclusions contained in the related report of examination. The primary purposes of workpapers are to—

- organize the material assembled during an examination to facilitate review and future reference.
- aid the examiner in efficiently conducting the examination.
- document the policies, practices, procedures and internal controls of the bank.
- provide written support of the examination and audit procedures performed during the examination.
- document the results of testing and formalize the examiner's conclusions.
- substantiate the assertions of fact or opinion contained in the report of examination.

They also are useful as—

- a tool for the examiner-in-charge to use in planning, directing, and coordinating the work of the assistants.
- a means of evaluating the quality of the work performed.
- a guide in estimating future personnel and time requirements.
- a record of the procedures used by the bank to assemble data for reports to the Board of Governors of the Federal Reserve System.
- a guide to assist in the direction of subsequent examinations, inquiries and studies.

The initial step in preparing workpapers is to review, where available, the applicable sections of supporting data prepared during the prior examination. When reviewing prior workpapers, the examiner should consider the data prepared in each area for—

- information that is of a continuing or permanent nature.
- guidance in preparation of workpapers for the current examination.
- an indication of changes or inconsistencies in accounting procedures or methods of their application since the last examination.

Accumulation of relevant documentation consistent with prior examinations, however, is often insufficient. Workpapers should be prepared in a manner designed to facilitate an objective review, should be organized to support an examiner's current findings and should document the scope of the current examination. Minimum content necessary for each section of workpapers includes:

Source of Information—This is important, not only in identifying the bank, but also in identifying the preparer. In subsequent examinations, the preparer should be able to readily determine the bank personnel from whom the information was obtained during the previous examination as well as the examiner who prepared the workpapers. Accordingly, each workpaper should include—

- bank name and subdivision thereof, either functional or financial.
- statement of title or purpose of the specific analysis or schedule.
- specific identification of dates, examination date and work performance date.
- initials of preparer and initials indicating review by the examiner designated to perform that function. Although appropriate use may be made of initials, the full names and initials of all examiners should appear on a time and planning summary or on an attachment to the file to facilitate future identification.
- name and title of person, or description of records, that provided the information needed to complete the workpaper.
- an index number identifying the workpaper and facilitating organization of the workpaper files.

Scope of Work—This includes an indication of the nature, timing and extent of testing in application of examination and audit procedures. It also includes the examiner's evaluation of and reliance on internal and external audit procedures and compliance testing of internal controls. To the extent that this information is contained in other workpapers, such as an examination procedure or a questionnaire, a reference to the appropriate workpaper will be sufficient.

Conclusions—The examiner should develop conclusions, in accordance with the examination objectives, with respect to the information obtained, documentation provided and the results of the examination and audit procedures performed. Such conclusions provide the basis for information contained in the report of examination.

To develop workpapers that have the qualities of clarity, completeness and conciseness, adequate planning and organization of content are essential. Therefore, before the workpaper is prepared, the examiner should determine the following:

- What examination objective will be satisfied by preparing the analysis or workpaper?
- Can preparation of the analysis be avoided by testing the bank's records and indicating the nature and extent of testing in an examination or an audit procedure or by comment on a related schedule or another supporting document?
- Is the analysis necessary to support the information in the report of examination?

Subsequent to the determination that an analysis is required, but before initiating preparation, the examiner should decide if—

- previous examination analyses can be adapted and carried forward to the current examination.
- the analysis can be prepared by an internal auditor or other bank personnel.
- the format of the analysis may be designed in a manner to facilitate its use in future examinations.

Once it has been determined that preparation of an analysis is required, the examiner should consider the following techniques that promote clarity of workpaper preparation:

- Restrict writing to only one side of the paper.
- Use a standard size sheet of paper large enough to avoid overcrowding.
- Condense information for simplicity.

Frequently, time can be saved by carrying forward workpapers from one examination to the next. Thus, when laying out an analysis that might be repeated in future examinations, the examiner should arrange it in a manner to facilitate future use. For example, extra columns may be left blank within an account analysis displaying little activity for insertion of transaction information during future examinations. In such a situation, appropriate space (boxes and column headings) should be provided for the signature or initials of the preparer and reviewer during each examination. When a workpaper is removed from one examination file and carried forward, a notation should be made in the file from which the paper is extracted. This is important in the event workpapers applicable to a particular examination are needed several years after the completion of the examination.

INITIAL PREPARATION BY OTHERS

Although all items included in the report of examination should be supported by workpapers, their preparation may not always require original work by the examiner. Frequently, arrangements can be made for bank personnel, including internal auditors, to prepare workpapers for examination use or to make available papers prepared by them as part of their regular duties. Examples include outstanding checklists, lists of outstanding certificates of deposit, schedules of employee borrowings, and debt maturity schedules. The extent to which examiners can utilize analyses and data prepared by bank personnel increases the efficiency with which examination procedures are completed.

As part of the initial examination planning process, arrangements should be made with appropriate bank management for the timely completion of bank-prepared data and information. The coordinating bank officer(s) must understand what information is being requested and why it is being requested, in order to avoid confusion and unnecessary regulatory burden. Arrangements, however, may have to be made for the bank to supply supporting details or other schedules or items to comply with the requests.

Upon receipt of bank-prepared analyses, an examiner should review the documents for overall completeness and note the date of receipt. This facilitates future planning and provides a ready reference as to which analyses have been received from the bank at any given point during the examination. Also, all bank-prepared workpapers should be tested and the nature and extent of testing performed by the examiner should be indicated on the papers.

INITIAL APPROACH IN WORKPAPER PREPARATION

The initial approach in preparing workpapers that support balances in the statement of condition is quantitative. In using this approach, the examiner obtains an analysis of the composition of the account balance as of the examination date. This inventory of the composition may be represented by a trial balance of loans, a listing of outstanding official checks, a listing of individual deposit accounts, or other similar items. Only after determining the composition and insuring that the total agrees with the bank's records is the examiner in a position to perform examination procedures and to arrive at a conclusion about the overall quality of the items comprising the balance.

For certain analyses, however, it is preferable to include account activity (transactions) in the workpapers. Typical examples of such analyses are those of bank premises and equipment and of reserve for possible loan losses. The format for reserve for possible loan losses should include beginning balances (prior examination ending balances), provisions for loan losses, collections, charge-offs, other transactions (transfers to/from undivided profits) and ending balances as of the examination date.

CONTROL AND REVIEW

All examiners assigned to an examination should insure that workpapers are controlled at all times while the examination is in progress. For example, when in the bank's offices, the workpapers should be secured at night and safeguarded during the lunch hour or at other times when no examining personnel are present in the immediate vicinity. It is essential to completely control confidential information provided by the bank. In addition, information relating to the extent of tests and similar details of examination procedures should not be made available to bank employees.

In cases where customary examination practices are not practical, alternative procedures and the extent to which they are applied should be documented. The need for completeness requires that there be no open items, unfinished operations or unanswered questions in the workpapers at the conclusion of the examination.

The clarity of workpapers should be such that an examiner or Federal Reserve official unfamiliar with the work could readily understand it. Handwritten commentaries should be legible, concise and should support the examiner's conclusions. Descriptions of work done, notations of conferences with bankers, conclusions reached and explanations of symbols used should be free from ambiguity or obscurity. Excessive use of symbols usually can be avoided by expanding a comment to include the nature and extent of work performed instead of using separate symbols for each portion of the work performed. In addition, instructions to assisting personnel concerning standards or workpaper content are necessary to ensure that they will meet the quality standards of the Federal Reserve. When workpapers have the necessary qualities of completeness, clarity, conciseness and neatness, a qualified reviewer may easily determine their relative value in support of conclusions and objectives reached. Incomplete, unclear or vague workpapers should, and usually will, lead a reviewer to the conclusion that the examination has not been adequately performed.

REVIEW PROCEDURES

Experienced personnel must review all workpapers prepared during an examination. Usually that review is performed by the examiner-in-charge, although in some cases, the examiner-in-charge may designate other experienced personnel to perform an initial review. An overall review is then performed by the examiner-in-charge. The two primary purposes of a review of workpapers by senior personnel are to determine that the work is adequate given the circumstances, and to ensure that the record is sufficient to support the conclusions reached in the report of examination. The timely review of workpapers and subsequent discussion of them with the individual who prepared them also is one of the more effective procedures for on-the-job training.

Normally, the review should be performed as soon as practicable after the completion of each work area. This review ideally occurs at the bank's office so that if the need for obtaining additional information arises or additional work is required the matter can be promptly attended to with minimum loss of efficiency.

When the review of workpapers is completed, the reviewer should sign or initial the applicable documents. Although all workpapers should be reviewed, the depth and degree of detail depends on factors such as:

- The nature of the work and its relative importance to the overall examination objectives.
- The extent to which the reviewer has been associated with the area during the examination.
- The experience of the examiners who have carried out the various operations.

Professional judgment must be exercised throughout the review process.

ORGANIZATION OF WORKPAPER FILES

Administration of an examination includes—

- organizing the workpaper files.
- delegating authority for completion of all applicable workpaper sections.
- reviewing and assembling the completed workpapers.

To ensure efficiency in locating information contained in the workpapers and completion of all necessary procedures, workpapers should be filed and indexed in a standard manner.

FILES

The file provides the organizational vehicle to assemble workpapers applicable to specific areas of the examination. Files might include detailed workpapers related to—

- management appraisal.
- overall conclusions about the condition of the bank.
- cash accounts.
- investments.
- loans.
- reserve for possible loan losses.
- bank premises and equipment.
- other assets.
- deposits.
- other liabilities.
- capital accounts and dividends.

Each individual file would normally include—

- related examination and audit procedures.
- detailed information and other documentation necessary to indicate the specific procedures performed, the extent of such procedures and the examiner's conclusions for the specific area.
- a summary, in comparative form, of the supporting general ledger balances with appropriate cross-references.

Judgment is required as to what the file should include on any specific examination. Lengthy documents should be summarized or highlighted (underlined) so that the examiner who is performing the work in the related area can readily locate the important provisions, without having to read the entire document. It also may be desirable to have a complete copy of the document in the file to support the summaries or answer questions of a specific legal nature.

Examples of documents that might be contained in the files are—

- a brief history and organization of the bank.
- organization charts of applicable departments within the bank.
- copies of, or excerpts from, the charter and bylaws.
- copies of capital stock certificates, debentures agreements and lease agreements.
- excerpts from minutes or contracts that are of interest beyond the current year.
- a chart of accounts and an accounting manual, if available, supplemented by descriptions of unique accounts and unusual accounting methods.
- lists of names and titles of the board of directors, important committees and relevant departmental personnel.

Indexing and Cross-Referencing

To promote efficiency and help ensure that all applicable areas of an examination have been considered and documented, the use of an indexing system aids in the organization of workpaper files. A general outline or index including all examination areas provides a basis for organization to which a numbering or other sequential system can be assigned and applied to each workpaper file.

When all workpapers pertinent to a specific area of the examination have been completed, a cover sheet listing the contents of each file should be attached to the front to provide a permanent record for reference. This permits not only efficient location of a set of workpapers pertinent to a specific area of the examination (for example, cash or commercial loans), but also facilitates the location of a specific analysis (or other document) within the set.

Amounts or other pertinent information appearing in more than one place in the workpapers should be cross-referenced between the analyses. A notation on the index, including appropriate cross-referencing of those items removed or filed elsewhere, facilitates location of specific data and records and also helps to prevent inadvertent loss of documents. An example is the cross-referencing of net charge-offs obtained in the review of the reserve for possible loan losses to the amount approved in the board of director's minutes. Proper cross-referencing is important because it—

- serves as a means of locating work performed for a particular account or group of accounts.
- identifies the source of supporting amounts in a particular analysis.
- facilitates the review of the workpapers.
- helps in following the workpapers during the succeeding examination.

WORKPAPER RETENTION

Examiners should retain on a readily available basis those workpapers from—

- the most recent full-scope Federal Reserve examination.
- the most recent general EDP examination.
- examinations of banks requiring or recommended for more than normal or special supervisory attention (composite rating of 3, 4 or 5; consumer compliance rating of 3, 4 or 5; EDP departments rated 4 or 5; or those subject to administrative action such as civil money penalties) until such banks are no longer the subject of such scrutiny.
- examinations disclosing conditions that may lead eventually to more than normal or special supervisory attention, as described above, until the supporting workpapers are no longer appropriate.
- examinations disclosing conditions that lead, or may eventually lead, to a criminal referral or criminal investigation.

These guidelines are the minimum required retention period for workpapers; longer retention periods may be set by individual Reserve Banks.

INTRODUCTION

The board of directors plays an essential role in the management of a bank's operations and is directly responsible for the soundness of the bank. As a result, in some cases, it is useful for Federal Reserve examiners and/or officers to meet with boards of directors. These meetings provide examiners with the opportunity to inform directors of examination findings, discuss the bank's plans and prospects with the board, and highlight important supervisory issues, particularly in cases that may require initiation of informal or formal supervisory actions. Meetings with boards of directors also provide examiners with a limited opportunity to ascertain the directors' knowledge of and interest in the bank's operations.

If Federal Reserve examiners believe it is necessary or desirable, they may conduct meetings with directors immediately after the on-site portion of an examination and before an examination report is completed and distributed. Such meetings are particularly encouraged when they can be conducted as part of regularly scheduled board meetings that coincide with the on-site examination.

When a bank is determined to be a problem or has exhibited significant deterioration, Federal Reserve examiners must conduct meetings with the directors. Such meetings require the participation of Federal Reserve officers and are typically conducted after the report of examination has been distributed.

GENERAL GUIDELINES

Meetings with boards of directors must be tailored to the individual circumstances of each bank, as well as to the Reserve Bank's supervisory objectives. As a result, uniform procedures for the conduct of these meetings cannot be specified. Nonetheless, the following guidelines should be considered when planning and conducting meetings with bank directors.

Content of Meetings

When participating in meetings with bank boards, examiners should present only information needed by, or relevant to, the directorate. This information varies depending on the bank's circumstances; however, examiners should inform the board of the examiner's assessment of the bank's condition; highlight any deficiencies requiring the board's attention; and solicit the board's views on the bank's condition, operations, and prospects. In addition, examiners should obtain the board's commitment to address promptly the deficiencies identified in the examination. Examiners should encourage inquiries and discussions with the directors to learn more about the directors' roles and performance and to foster a good working relationship with them.

Data supporting the examiner's conclusions and comments should be prepared and presented to board members in a professional manner. Slides, handouts, and other visual aids are encouraged. Comparative figures and ratios from previous and present examinations should be reviewed prior to the meeting, with handouts and visual aids highlighting adverse trends.

Outlines for Meetings

Examiners should prepare detailed outlines of each meeting's discussion points and goals. Following is a sample outline that examiners may use as a guide to prepare for meetings with directors. It is not all-inclusive, and examiners should not be limited by its content in developing their own presentations. Generally, comments on these items are warranted when concerns have arisen during the current examination, or when significant changes—positive or negative—have occurred since the last examination.

I. Introductory remarks by Federal Reserve Bank official or examiner
   A. Federal Reserve Bank policy regarding board meeting
   B. Purpose of the meeting
II. Examiner's presentation
   A. Duties and responsibilities of directors
      1. Effectively supervise the bank's affairs
      2. Select competent management
      3. Adopt and follow sound, written policies and objectives
      4. Avoid self-serving practices

5. Be informed of the bank's financial condition and management policies
6. Maintain reasonable capitalization
7. Observe banking laws and regulations

B. Adequacy and effectiveness of policies and procedures
1. Lending
2. Investments
3. Asset/liability management
4. Personnel
5. Operations

C. Adequacy and accuracy of bank's reporting systems
1. Reports of the board and committees
2. Management reports to the board
3. Management information systems
4. Regulatory reports

D. Condition of the bank/results of the examination
1. Asset quality
2. Violations of law, evidence of self-dealing
3. Capital
4. Management
5. Liquidity
6. Earnings
7. Internal controls and audit coverage
8. Future prospects
9. Relationships with bank holding company

E. Required corrective action on problems and board commitment

III. Summary of overall conclusions

IV. Questions from the board

Procedural Issues

In general, meetings with the full board are preferable. In certain cases, however, a Reserve Bank may determine that meeting with a board committee, such as the executive or audit committee, will fulfill the Reserve Bank's supervisory objectives. Any person connected with the bank, such as an attorney, auditor, or holding company representative, may attend the board of directors meeting at which the overall findings and conclusions of the examination are discussed. The attendance of any such party should be noted in the minutes of the meeting. However, the examiner may excuse such persons during any portion of his or her presentation if deemed appropriate. Attendance by honorary directors to participate in discussions and review the examination report is also permitted.

Generally, at least one member of a Reserve Bank's official staff is expected to represent the Federal Reserve at meetings with directors of banks. However, for meetings with the directors of banks that have less than $500 million in assets, Reserve Banks are granted the discretion to have senior examination staff represent the Reserve Bank. The participation of Reserve Bank presidents in meetings with directors is left to the discretion of the Reserve Bank.

To the extent possible, meetings with the boards of directors of state member banks should include representatives of the relevant state banking authority. A meeting with the directors of a bank that is owned by a holding company may be held at the same time as a meeting with the directors of the holding company, when appropriate.

Whenever a meeting is held between an examiner and a board, the examiner should prepare written comments on the meeting for examination workpapers.

MEETINGS WITH BOARDS OF PROBLEM BANKS AND BANKS EXHIBITING SIGNIFICANT DETERIORATION

When an examination reveals that a bank has significant problems, Federal Reserve policy requires that a meeting be held with its board of directors. The policy further requires that a written summary of examination findings—separate from the complete examination report—be distributed to each director in such cases. A senior Reserve Bank official also must participate in communicating and presenting examination findings on problem banks to their boards of directors. This policy's objective is to ensure that each director of a state member bank considered to be a problem or to have a significant weakness clearly understands the nature and dimension of the problems, as well as the joint and several responsibility of the directors to effect correction.

Criteria Requiring Meetings with Problem Banks

A meeting with the board of directors is to be held after any full-scope examination in which a state member bank is assigned a CAMELS composite rating of 4 or 5. A meeting is also required if a bank is rated composite 3 and its condition appears to be deteriorating or has shown little improvement since a previous examination in which it received a composite 3 rating. Furthermore, a meeting should be held after a targeted examination if deemed appropriate and desirable by the Reserve Bank. An official of the Reserve Bank and the examiner-in-charge should also meet with a board if any of the following conditions exist:

- The bank is entering into a formal written agreement with the Federal Reserve, a cease-and-desist order is being issued, or the bank is being placed under a memorandum of understanding.
- The bank is already operating under a supervisory action but is in noncompliance with significant provisions or has experienced significant deterioration since the action was initiated.
- Self-serving activities or other unsafe and unsound practices exist in the bank.
- Any other condition or practice that places, or could place, the bank in a seriously weakened or extended condition has been identified during the examination.

Additional Guidelines

Senior Reserve Bank officials are expected to participate in meetings with the directors of problem banks, with the seniority of the participating official determined by the condition and size of the bank. The larger the organization or the more serious its problems, the more senior the Federal Reserve official should be.

A meeting with the board of directors of a problem or deteriorating bank should include a formal, structured presentation with a clear statement that the bank is considered a "problem institution" or is about to become a problem institution if existing conditions deteriorate. The presentation should further make clear the nature of problems confronting the bank, citing examination findings such as the following:

- deficiencies in capital, asset quality, earnings, or liquidity
- violations of law
- inadequacies in policies, practices, and reporting systems necessary for proper risk management and organizational administration
- lack of well-documented lending, collection, investment, asset/liability management, and risk-management policies or the failure to ensure that such policies are being followed
- failure of management to address previously discussed deficiencies
- lack of reporting systems sufficient to keep senior management and the board of directors fully informed
- failure of the board of directors to ensure the active management of the organization

MEETINGS WITH BOARDS OF MULTINATIONAL AND MAJOR REGIONAL BANKS

A meeting with the board of directors is required after every full-scope examination of a multinational organization or major regional organization with assets in excess of $5 billion. Reserve Banks also are encouraged to conduct such meetings after every full-scope examination of a regional bank with assets in excess of $1 billion.

MEETINGS WITH BOARDS OF DE NOVO BANKS

After the approval of a membership application, but before a de novo bank is opened, Reserve Bank staff should meet with the full board of directors to discuss applicable statutes, regulations, policies, and supervisory procedures. As with all meetings with directors, the agenda for this meeting should be tailored to the individual circumstances of the bank. At a minimum, the Reserve Bank should apprise the directors of their responsibilities and emphasize their need to adhere to sound operating policies.

DIRECTOR'S SUMMARY OF EXAMINATION FINDINGS

In addition to the report of examination, Federal Reserve Banks must provide written reports to directors summarizing the examination findings for all banks rated composite 3, 4, or 5, and for those rated composite 1 or 2 that show signs of significant deterioration in condition or apparent violations of law. The summary reports should focus on identified problems—rather than on the strength of the organization—and present the bank's deficiencies succinctly and clearly. In all cases, the types of actions directors and management should take to address identified problems should be specifically stated. Directors of institutions rated 4 or 5 are to be told their banks are ''problem'' institutions that warrant ''special supervisory attention.'' Directors of banks rated 3 are to be informed that the bank's condition is ''not satisfactory,'' that the bank is subject to ''more-than-normal supervision,'' and that the bank may become a ''problem'' if weaknesses are not addressed adequately.

Summary reports should emphasize the responsibilities of the directors to ensure that corrective actions are taken to address all deficiencies noted in the pages of the full bank examination report entitled ''Matters Requiring Board Attention'' and ''Examination Conclusions and Comments.'' In addition, the organization, style, and content of the summary report should be similar, if not identical, to the text of these report pages.

Summary reports should be sent directly to the bank's management for distribution to each director. The transmittal letter to the bank should state the report is a summary of identified problems and contemplated supervisory actions and direct bank management to distribute the summary report to each director. The letter should further instruct each director to read the report, sign the introductory statement attesting to having read the report, and return the report to management. Management should keep copies of the directors' signed statements on file, but should destroy all but one file copy of the summary report itself.

The summary report must be completed and distributed before any meeting between Reserve Bank officials and the bank's board of directors, to provide the directors with prior notice of deficiencies to be discussed. Reserve Banks should also make every effort to distribute the complete examination report to management before meeting with a board of directors.

Meetings with Board of Directors
Examination Objectives
Effective date March 1984

Section 1040.2

1. To foster a better understanding of the respective roles of directors and examiners.
2. To inform the directors of the examination scope and the bank's condition.
3. To obtain information concerning future plans and proposed changes in bank policies that may have significant impact on the future condition of the bank.
4. To reach an agreement on any significant problems.
5. To obtain a commitment to initiate appropriate corrective action.

1. Inform management that a meeting will be held with the board of directors. State the Federal Reserve Bank's policy and the purpose of the meeting and establish a tentative date.
2. Finalize the time and place of the meeting when confident that a thorough understanding of the condition of the bank will be developed. If the meeting is to be a "special meeting" resulting from serious areas of concern, perform procedure 7.
3. Develop an outline of matters to be covered at the meeting by reviewing results of the examination.
4. Prepare supportive data for the meeting by:
   a. Compiling a list of comments and criticisms.
   b. Preparing schedules of comparative figures for discussion.
   c. Affirming that the bank has responded adequately to Reserve Bank requests.
   d. Preparing questions to elicit opinions and attitudes of individual board members.
5. Prepare a brief formal agenda for the meeting and reproduce enough copies to distribute to participants.
6. If it is decided that a meeting will be held:
   a. Communicate with Reserve Bank office to:
      - Notify office staff of the proposed date and place of the meeting. (Confirm time and place when final.)
      - Determine whether a Reserve Bank official will attend.
      - Determine whether the Reserve Bank official has suggestions for the agenda.
   b. Submit a copy of the agenda and outline in advance to the Reserve Bank official.
   c. Inform directors that the following must be submitted to the Reserve Bank office:
      - A copy of a board resolution stating corrective action.
      - A written plan for corrective action to be forwarded within a specified time period.
      - Periodic progress reports.
7. For "special meetings" resulting from serious problems:
   a. Communicate with the Reserve Bank to:
      - Notify office staff of the proposed date and place of the meeting.
      - Determine whether a Reserve Bank official will attend.
      - Determine whether the Reserve Bank official has suggestions for the agenda.
   b. Confirm the final time and place of the meeting with the Reserve Bank office.
   c. Prepare any special supporting data for the meeting, such as areas of noncompliance with memorandums of understanding or cease and desist agreements or orders.
8. Conduct the board meeting in accordance with the agenda and previously prepared outline, being certain to discuss:
   a. Major criticisms noted during the examination.
   b. Conclusions reached about the bank in general.
   c. Expected future conditions.
   d. Potential problems.
   e. Planned corrective action:
      - Examiner's recommendations.
      - Management's commitments.
      - Director's commitments.
9. Obtain a definite agreement or commitment from the board that appropriate corrective action will be taken.
10. Prepare a memorandum covering the meeting with the board to include, as a minimum:
    a. The time and place of the meeting.
    b. The directors and guests in attendance.
    c. The matters subject to criticism that were reviewed.
    d. A summary of the general discussion on the matters presented to the board.
    e. A summary of the director's reaction to the situation and any commitments obtained from them.
11. Request that copies of the minutes of the board meeting be forwarded to the Reserve Bank and the examiner-in-charge.

The Federal Reserve Board has a broad range of enforcement powers over both domestic and foreign financial institutions and over the individuals associated with them. Generally, formal or informal enforcement actions are taken after the completion of an onsite bank examination. These examinations include commercial, trust, electronic data-processing, consumer, or other types of examinations. Formal or informal enforcement actions may also be taken when a Reserve Bank becomes aware of a problem at a bank that warrants immediate attention and correction.

In addition to the Board's jurisdiction over financial institutions, the Board also has jurisdiction over individuals associated with financial institutions. The term "institution-affiliated party" includes any officer, director, employee, controlling shareholder, or agent of a financial institution, and any other person who has filed or is required to file a change-in-control notice. It also includes any shareholder, consultant, joint-venture partner, or any other person who participates in the conduct of the affairs of the financial institution as well as any independent contractors, including attorneys, appraisers, and accountants, who knowingly or recklessly participate in any violation of law or regulation, breach of fiduciary duty, or unsafe or unsound practice that causes (or is likely to cause) more than a minimal financial loss to, or a significant adverse effect on, a financial institution.[1] The Board's jurisdiction over an institution-affiliated party extends for up to six years after the party's resignation, termination of employment, or separation caused by the closing of a financial institution, provided that any notice (such as a notice of intent to remove from office and of prohibition) is served on the party before the end of a six-year period.

FORMAL SUPERVISORY ACTIONS

The following statutory tools are available to the Board in the event formal supervisory action is warranted against a state member bank or any institution-affiliated party. The objective of formal action is to correct practices that the regulators believe to be unlawful, unsafe, or unsound.[2] The initial consideration and determination of whether formal action is required usually results from examination findings. It is important to provide adequate support for all recommendations for both formal and informal actions in the examination report and associated workpapers.

Types of Supervisory Actions

Generally, under section 8 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1818(b), the Board may use its cease-and-desist authority and civil money penalty authority against any state member bank and any institution-affiliated party that meets the statutory criteria for issuing such an order. Prohibition and removal actions may be taken against any institution-affiliated party who meets the statutory criteria to bring such an action.

Cease-and-Desist Orders

Generally, under 12 USC 1818(b), the Board may use its cease-and-desist authority against a state member bank and any institution-affiliated party when it finds that a bank or party is engaging, has engaged, or is about to engage in (1) a violation of law, rule, or regulation; (2) a violation of a condition imposed in writing by the Board in connection with the granting of any application or any written agreement; or (3) an unsafe or unsound practice in conducting the business of the institution. Separately, under 12 USC 1818(s), the Board must initiate a cease-and-desist action against a bank when it has failed to establish and maintain the Bank Secrecy Act procedures required by the Board's Regulation H or has failed to correct any previously noted deficiencies related to these procedures.

A cease-and-desist order may require the bank or person subject to the order to (1) cease

1. The Board is authorized to issue regulations further defining which individuals should be considered institution-affiliated parties. Similarly, the Board may determine whether an individual is an institution-affiliated party on a case-by-case basis. (See 12 USC 1813(u).)

2. An unsafe or unsound practice is defined as any action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

and desist from the practices or violations or (2) take affirmative action to correct the violations or practices. Affirmative actions include actions necessary to restore the bank to a safe and sound condition, such as measures to improve asset quality. The order may also include restrictions on growth, debt, and dividends; require the disposition of any loan or asset; require the employment of qualified officers or employees; require restitution, reimbursement, indemnification, or guarantee against loss if the bank or person was unjustly enriched by the violation or practice or if the violation or practice involved a reckless disregard for the law or applicable regulations or a prior order; and any other action the Board determines to be appropriate.

Most cease-and-desist orders are issued by consent. When Board staff, in conjunction with the appropriate Reserve Bank, determines that a cease-and-desist action is necessary, the bank or person is generally given an opportunity to consent to the issuance of the order without the need for the issuance of a notice of charges and a contested administrative hearing. Board staff drafts the proposed cease-and-desist order and, with Reserve Bank staff, presents it to the bank or individual for consent. Banks or individuals are advised that they may have legal counsel present at all meetings with Board or Reserve Bank staff concerning formal supervisory actions. If the parties voluntarily agree to settle the case by the issuance of a consent cease-and-desist order, the proposed consent order will be presented to senior Board officials for approval, at which time the order will be final and binding.

When a bank or person fails to consent to a cease-and-desist order, the Board may issue a notice of charges and of hearing to the bank or party. The notice of charges contains a detailed statement describing the facts constituting the alleged violations or unsafe or unsound practices. The issuance of the notice of charges and of hearing starts a formal process that includes the convening of a public administrative hearing[3] conducted before an administrative law judge, appointed by the Board. After the hearing, the judge makes a recommended decision to the Board. A hearing must be held within 30 to 60 days of service of the notice of charges, unless a later date is set by the administrative law judge. After the Board considers the record of the proceeding, including the administrative law judge's recommended decision, it determines whether to issue a final cease-and-desist order. Banks and individuals who are subject to cease-and-desist orders that were issued as a result of contested proceedings may appeal the order to the appropriate federal court of appeals.

3. A private hearing may be held if the Board determines that holding a public hearing would be contrary to the public interest.

Temporary Cease-and-Desist Orders

If a violation or threatened violation of law, rule, or regulation, or if engaging in an unsafe or unsound practice that is specified in the notice of charges, is likely to cause the bank's insolvency, cause significant dissipation of the bank's assets or earnings, weaken the bank's condition, or otherwise prejudice the interests of depositors before the completion of the proceedings (initiated by the issuance of the notice of charges), the Board may, in conjunction with issuing a notice of charges, issue a temporary cease-and-desist order against the bank to effect immediate correction (pursuant to 12 USC 1818(c)).

The Board may also issue a temporary order if it determines that the bank's books and records are so incomplete or inaccurate that the Board is unable to determine, through the normal supervisory process, the bank's financial condition or the details or purpose of any transaction that may have a material effect on the bank's condition. The temporary order may require the bank to take the same corrective actions as a cease-and-desist order. The advantage of issuing a temporary cease-and-desist order is that it becomes effective immediately after it is served on the bank or individual. Within 10 days after being served with a temporary order, however, the entity or individual may appeal to a U.S. district court for relief from the order. Unless set aside by the district court, the temporary order stays in effect until the Board issues a final cease-and-desist order or dismisses the action.

Written Agreements

When circumstances warrant a less severe form of formal supervisory action, a written agreement may be used. A written agreement is generally with the Reserve Bank under delegated authority (12 CFR 265.11(a)(15)). Written agreements are drafted by Board staff, in consultation with Reserve Bank staff, and must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the General Counsel before issuance. The provisions of a written agreement may relate to any of the problems found at the bank or to any problems involving institution-affiliated parties.

Prompt-Corrective-Action Directives

Please see section 4133.1 for a discussion of prompt-corrective-action directives, which are a type of formal supervisory action issued when a bank's capital ratios fall below certain specified levels.

Prohibition and Removal Authority

The Board is authorized by 12 USC 1818(e) to remove any current institution-affiliated party of a bank for certain violations and misconduct and to prohibit permanently from the banking industry any current or former institution-affiliated party from future involvement with any insured depository institution, bank or thrift holding company, and nonbank subsidiary.[4]

The Board is authorized to initiate removal or prohibition actions when

- the institution-affiliated party has directly or indirectly—
  - — violated any law, regulation, cease-and-desist order, condition imposed in writing, or written agreement;
  - — engaged in any unsafe or unsound practice; or
  - — breached a fiduciary duty;
- the Board determines that, because of the violation, unsafe or unsound practice, or breach—
  - — the institution has suffered or will probably suffer financial loss or other damage;
  - — the interests of depositors have been or could be prejudiced by the violation, practice, or breach; or
  - — the institution-affiliated party has received financial gain or other benefit from the violation, practice, or breach; and
- the violation, practice, or breach—
  - — involves personal dishonesty or
  - — demonstrates a willful or continuing disregard for the safety or soundness of the institution.

The statute also authorizes the Board to initiate removal or prohibition actions against (1) any institution-affiliated party who has committed a violation of any provision of the Bank Secrecy Act that was not inadvertent or unintentional, (2) any officer or director of a bank who has knowledge that an institution-affiliated party has violated the money-laundering statutes and did not take appropriate action to stop or prevent the reoccurrence of such a violation, or (3) any officer or director of a bank who violates the prohibitions on management interlocks. These removal or prohibition actions for these violations do not require a finding of gain to the individual, loss to the institution, personal dishonesty, or willful or continuing disregard for the safety or soundness of the institution.[5]

If an institution-affiliated party's actions warrant immediate removal from a state member bank, the Board is authorized to suspend the person temporarily from that bank pending the outcome of the complete administrative process. An institution-affiliated party presently associated with a bank may also be suspended or removed for cause based on actions taken while formerly associated with a different insured depository institution, bank holding company, or "business institution." Business institution is not specifically defined in the statute so that it may be interpreted to include any other business interests of the institution-affiliated party.

Under 12 USC 1818(g), the Board is authorized to suspend from office or prohibit from further participation any institution-affiliated party charged or indicted for the commission of a crime involving personal dishonesty or breach of trust that is punishable by imprisonment for a term exceeding one year under state or federal law, if the continued participation might threaten either the interests of depositors or public confidence in the bank. The Board may also suspend or prohibit any individual charged with a violation of the money-laundering statutes. The suspension can remain in effect until the criminal action is disposed of or until the suspension is terminated by the Board. The Board may also initiate a removal or prohibition action against

4. This authority is distinct from the Board's authority under prompt corrective action to dismiss senior officers from a particular bank.

5. See 12 USC 1818(e)(2).

an institution-affiliated party who has been convicted of, or pleaded to, a crime involving personal dishonesty or breach of trust if his or her continued service would threaten the interests of the depositor or impair public confidence in the institution. The Board is required to issue such an order against any institution-affiliated party who has been convicted of, or pleaded to, a violation of the money-laundering statutes.

Furthermore, 12 USC 1829 prohibits any individual who has been convicted of a crime involving dishonesty, breach of trust, or money laundering from (1) serving as an institution-affiliated party of, (2) directly or indirectly participating in the affairs of, and (3) owning or controlling, directly or indirectly, an insured depository institution without the Federal Deposit Insurance Corporation's (FDIC's) prior approval. The statute also prohibits a convicted person from holding a position at a bank holding company or nonbank affiliate of a bank without the prior approval of the Board of Governors of the Federal Reserve System. The penalty for violation of this law is a potential fine for a knowing violation of up to $1 million per day, imprisonment for up to five years, or both. The criminal penalty applies to both the individual and the employing institution.

Violations of Final Orders and Written Agreements

When any final order or temporary cease-and-desist order has been violated, the Board may apply to a U.S. district court for enforcement of the action. The court may order and require compliance.

Violations of final orders and written agreements may also give rise to the assessment of civil money penalties against the offending bank or institution-affiliated party, as circumstances warrant. The civil money penalty is assessed in the same manner as described in the "Civil Money Penalties" subsection below. Any institution-affiliated party who violates a suspension or removal order is subject to a criminal fine of up to $1 million, imprisonment for up to five years, or both.

Civil Money Penalties

The Board may assess civil money penalties of up to $7,500 per day against any institution or institution-affiliated party for any violation of (1) law or regulation; (2) a final cease-and-desist, temporary cease-and-desist, suspension, removal, or prohibition order or for failure to comply with a prompt-corrective-action directive; (3) a condition imposed in writing by the Board in connection with the granting of an application or other request; and (4) a written agreement.

A fine of up to $37,500 per day can be assessed for a violation, an unsafe or unsound practice recklessly engaged in, or a breach of fiduciary duty when the violation, practice, or breach is part of a pattern of misconduct, causes or is likely to cause more than a minimal loss to the bank, or results in pecuniary gain or other benefit for the offender. A civil money penalty of up to $1.375 million per day can be assessed for any knowing violation, unsafe or unsound practice, or breach of any fiduciary duty when the offender knowingly or recklessly caused a substantial loss to the financial institution or received a substantial pecuniary gain or other benefit. Civil money penalties may also be assessed, under the three-tier penalty framework described above, for any violation of the Change in Bank Control Act and for violations of the anti-tying provisions of federal banking law, among other provisions.[6]

The Board may also assess civil money penalties for the submission of any late, false, or misleading call reports. If a financial institution maintains procedures that are reasonably adapted to avoid inadvertent errors, but unintentionally fails to publish any report, submits any false or misleading report or information, or is minimally late with the report, it can be assessed a fine of up to $2,200 per day. The financial institution has the burden of proving that the error was inadvertent under these circumstances. If the error was not inadvertent or the bank lacked the appropriate procedures, a penalty of up to $32,000 per day can be assessed for all false or misleading reports or information submitted to the Board. If the submission was done in a knowing manner or with reckless disregard for the law, a fine of up to $1.375 million or 1 percent of the institution's assets, whichever is less, can be assessed for each day

6. See 12 USC 1972.

of the violation. Under its general civil money penalty authority, the Board may also assess civil money penalties against any institution-affiliated party who participates in a bank's filing of late, false, or misleading call reports.

Administration of Formal Actions

Publication of Final Orders

Under 12 USC 1818(u), the Board is required to publish and make publicly available any final order issued for any administrative enforcement proceeding it initiates. These orders include cease-and-desist, removal, prohibition, and civil money penalty assessments. The Board is also required to publish and make publicly available any written agreement or other written statement that it may enforce, unless the Board determines that publication of the order or agreement would be contrary to the public interest.

Public Hearings

Under 12 USC 1818(u), all formal hearings, including contested cease-and-desist, removal, and civil money penalty proceedings, are open to the public unless the Board determines that a public hearing would be contrary to the public interest. Transcripts of all testimony; copies of all documents submitted as evidence in the hearing, which could include examination or inspection reports and supporting documents (except those filed under seal); and all other documents, such as the notice and the administrative law judge's recommended decision, are available to the public. These documents could include examiners' workpapers, file memorandums, reports of examination and inspection, and correspondence between a problem institution or wrongdoer and the Federal Reserve Bank. Appropriate actions should always be taken to ensure that all written material prepared in connection with any supervisory matter be accurate and free of insupportable conclusions or opinions.

Appointment of Directors and Senior Executive Officers

Under section 32 of the FDI Act (12 USC 1831i) and subpart H of Regulation Y (12 CFR 225.71 et seq.), any state member bank or bank holding company that is in a troubled condition[7] or does not meet minimum capital standards must provide 30 days' written notice to the Board of Governors before appointing any new director or senior executive officer.[8] This requirement also applies to any change in the responsibilities of any current senior executive officer who is proposing to assume a different senior officer position. Subpart H of Regulation Y details the procedures for filing and the content of the notice. The Board may disapprove a notice if it finds that the competence, experience, character, or integrity of the proposed individual indicates that his or her service would not be in the best interest of the institution's depositors or the public. A disapproved individual or the institution that filed the notice may appeal the Federal Reserve's notice of disapproval under the procedures detailed in Regulation Y. The individual may not serve as a director or senior executive officer while the appeal is pending. In the event that a state member bank or bank holding company that is in a troubled condition appoints a director or senior officer without the required 30 days' prior written notice, appropriate follow-up supervisory action should be taken.

INFORMAL SUPERVISORY ACTIONS

Informal supervisory tools are used when circumstances warrant a less severe form of action than the formal supervisory actions described above. Informal actions are not enforceable and their violation cannot serve as a basis for assessing a civil money penalty or initiating a removal and prohibition action. Informal actions are not published or publicly available. These informal actions include commitments, Board resolutions, and memoranda of understanding.

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7. As defined in section 225.71 of the Board's Regulation Y, a state member bank or holding company is in troubled condition if it (1) has a composite rating, determined at its most recent examination, of 4 or 5; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the bank's financial condition; or (3) is expressly informed by the Board or Reserve Bank that it is in troubled condition.

8. The Board or Reserve Bank may permit, under extraordinary circumstances, an individual to serve as a director or senior executive officer before a notice is provided; however, this permission does not affect the Federal Reserve's authority to disapprove a notice within 30 days of its filing. The Board may extend the review period to a maximum of 90 days if needed to process the notice.

- *Commitments* are generally used to correct minor problems or to request periodic reports addressing certain aspects of a bank's operations. Commitments may be used when there are no significant violations of law or unsafe or unsound practices and when the bank and its officers and directors are expected to cooperate and comply.[9] Commitments are generally obtained by the Reserve Bank's sending a letter to the bank outlining the request and asking for a response and an indication that the commitments are accepted.
- *Board resolutions* generally represent a number of commitments made by the bank's directors and are incorporated into the bank's corporate minutes. The Reserve Bank may request board resolutions in the examination transmittal letter, which asks the bank to provide it with a signed copy of the corporate resolution.
- *Memoranda of understanding (MOU)* are highly structured written, but informal, agreements that are signed by both the Reserve Bank and the bank's board of directors. An MOU is generally used when a bank has multiple deficiencies that the Reserve Bank believes can be corrected by the present management.

INDEMNIFICATION PAYMENTS AND GOLDEN PARACHUTE PAYMENTS

In general, an indemnification payment is a payment that reimburses an insider for a specified liability or cost that the person incurred in connection with a Federal Reserve investigation or enforcement action. Golden parachute payments are severance payments or agreements to make severance payments that are paid or entered into at a time when the bank or holding company is in a troubled condition. These payments require the prior written approval of the institution's primary federal regulator and the concurrence of the FDIC. Although both types of payments fall under the same statute—section 18(k) of the FDI Act (12 USC 1828(k)) and the FDIC's accompanying regulations[10]—the two types of payments are quite different and distinct. However, some of the restrictions on these payments are the same or similar.

Indemnification Agreements and Payments

State member banks may seek to indemnify their officers, directors, and employees from any judgments, fines, claims, or settlements, whether civil, criminal, or administrative. The bylaws of some state member banks may have broadly worded indemnification provisions, or the bank may have entered into separate indemnification agreements that cover the ongoing activities of its own institution-affiliated parties. Such indemnification provisions may be inconsistent with federal banking law and regulations, as well as with safe and sound banking practices.

Supervisory and examiner staff should be alert to the limitations and prohibitions on indemnification imposed by section 18(k) of the FDI Act and the regulations issued thereunder by the FDIC. The law and regulations apply to indemnification agreements and payments made by any bank to any institution-affiliated party, regardless of the condition of the financial institution. The purpose of the law and regulations is to preserve the deterrent effects of administrative enforcement actions (by ensuring that individuals subject to final enforcement actions bear the costs of any judgments, fines, and associated legal expenses) and to safeguard the assets of financial institutions.

A prohibited indemnification payment includes any payment (or agreement to make a payment) by a state member bank to an institution-affiliated party to pay or reimburse such person for any liability or legal expense incurred in any Board administrative proceeding that results in a final order or settlement in which the institution-affiliated party is assessed a civil money penalty, is removed or prohibited from banking, or is required to cease an action or take any affirmative action, including making restitution, with respect to the bank.

The FDIC's regulations provide criteria for making permissible indemnification payments. 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 the best

9. Informal commitments are distinct from conditions imposed in writing in connection with the grant of an application or other request by an institution, which may be enforced through the imposition of a civil money penalty.

10. See 12 CFR 359.

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 law and the FDIC's regulations apply to all state member banks. They reinforce the Federal Reserve's longstanding policy that an institution-affiliated party who engages in misconduct should not be insulated from the consequences of his or her misconduct. From a safety and soundness perspective, a state member bank should not divert its assets to pay a fine or other final judgment issued against an institution-affiliated party for misconduct that presumably violates the bank's policy of compliance with applicable law, especially in cases where the individual's misconduct has already harmed the bank.

State member banks should review their bylaws and any outstanding indemnification agreements, as well as insurance policies, to ensure that they conform with the requirements of federal law and regulations. If a state member bank fails to take appropriate action to bring its indemnification provisions into compliance with federal laws and regulations, appropriate follow-up supervisory action may be taken. As part of the supervisory process, which will include merger and acquisition applications, the Federal Reserve's supervisory and examiner staff will review identified agreements having indemnification-related issues for compliance with federal law and regulations. (See SR-02-17.)

Golden Parachute Payments

The FDIC's golden parachute regulations apply to an insured depository institution that is in a troubled condition as defined in Regulation Y. The purposes of the law and regulations are to safeguard the assets of financial institutions and limit rewards to institution-affiliated parties who contributed to the institution's troubled condition.

In general, the FDIC's regulations (12 CFR 359) prohibit insured depository institutions and their holding companies from making golden parachute payments except in certain circumstances. A golden parachute payment means any payment in the nature of compensation (or an agreement to make such a payment) for the benefit of any current or former institution-affiliated party of an insured depository institution or its holding company that meets three criteria. First, the payment or agreement must be contingent on the termination of the institution-affiliated party's employment or association. Second, the payment or agreement is received on or after, or made in contemplation of, among other things, a determination that the institution or holding company is in a troubled condition under the regulations of the applicable banking agency. Third, the payment or agreement must be payable to an institution-affiliated party who is terminated when the institution or holding company meets certain specific conditions, including being subject to a determination that it is in a troubled condition.

The definition of a golden parachute payment also covers a payment made by a bank holding company that is not in a troubled condition to an institution-affiliated party of an insured depository institution subsidiary that is in a troubled condition, if the other criteria in the definition are met. This circumstance may arise when a bank holding company, as part of an agreement to acquire a troubled bank or savings association, proposes to make payments to the troubled institution's institution-affiliated parties that are conditioned on their termination of employment.[11]

A state member bank or bank holding company may make or enter into an agreement to make a golden parachute payment only (1) if the Federal Reserve, with the written concurrence of the FDIC, determines that the payment or agreement is permissible; (2) as part of an agreement to hire competent management in certain conditions, with the consent of the Federal Reserve and the FDIC as to the amount and terms of the proposed payment; or (3) pursuant to an agreement to provide a reasonable severance not to exceed 12 months' salary in the event of an unassisted change in control of the depository

11. The FDIC's regulations exclude from the definition of a golden parachute payment several types of payments, such as payments made pursuant to a qualified pension or retirement plan; a benefit plan or bona fide deferred compensation plan (which are further defined in the FDIC's regulations); or a severance plan that provides benefits to all eligible employees, does not exceed the base compensation paid over the preceding 12 months, and otherwise meets the regulatory definition of nondiscriminatory and other conditions in the FDIC's regulations.

institution, with the consent of the Federal Reserve. In determining the permissibility of the payment, the Federal Reserve may consider a variety of factors, including the individual's degree of managerial responsibilities and length of service, the reasonableness of the payment, and any other factors or circumstances that would indicate that the proposed payment would be contrary to the purposes of the statute or regulations.

A state member bank or bank holding company requesting approval to make a golden parachute payment or enter into an agreement to make such a payment should submit its request simultaneously to the appropriate FDIC regional office and the Reserve Bank. The request must detail the proposed payments and demonstrate that the state member bank or bank holding company does not possess and is not aware of any evidence that there is reasonable basis to believe, at the time that the payment is proposed to be made, that (1) the institution-affiliated party receiving such a payment has committed any fraud, breach of fiduciary duty, or insider abuse or has materially violated any applicable banking law or regulation that had or is likely to have a material adverse effect on the bank or company; (2) that the individual is substantially responsible for the institution's insolvency or troubled condition; (3) and that the individual has violated specified banking or criminal laws.

Requests regarding golden parachute payments or agreements should be forwarded by the Reserve Bank to the appropriate Board staff for a final determination on the permissibility of the payment. Golden parachute payments or agreements must be approved by the Board's Director of the Division of Banking Supervision and Regulation and the General Counsel. Denials are not delegated by the Board of Governors to Board or Reserve Bank staffs.

If a state member bank or bank holding company makes or enters into an agreement to make a golden parachute payment without prior regulatory approval when such an approval is required, appropriate follow-up supervisory action should be taken. This follow-up could include an enforcement action requiring the offending institution-affiliated party to reimburse the institution for the amount of the prohibited payment. When state member banks or bank holding companies are identified as having golden parachute-related issues in the supervisory process, those issues should be carefully reviewed for compliance with the law and the FDIC's regulations. The appropriate Reserve Bank supervisory staff and the appropriate staff of the Board's Division of Banking Supervision and Regulation and Legal Division should be notified and consulted on the golden parachute-related issues.

The examiner is encouraged to use objective criteria in evaluating various areas of the bank. However, there will always be a need for subjective judgment in an examination. Formulating an overall conclusion regarding the present and future condition of the bank requires the use of both objective criteria and subjective judgment. As experience is essential in evaluating information in areas requiring subjective judgment, the procedures in this section should be performed by the Central Point of Contact (CPC) or the examiner-in-charge (EIC) (EIC is meant to include the CPC). When performing these procedures, the examiner's primary concerns are—

- to make the ultimate determination as to—
  - the solvency of the bank and its ability to meet maturing and unusual demands in the ordinary course of business,
  - adherence to safe and sound banking practice,
  - adherence to the law, and
  - the continued viability of the institution, and
- to communicate the results of the examination to the Federal Reserve System and the directors of the bank.

The evaluation of the overall condition of the bank is based on conditions found throughout the institution. Considerations include internal control and policy exceptions, violations of law and regulations, quality of management, adequacy of earnings and capital, quantities of classified assets, and other identified deficiencies or irregularities. An evaluation of the future condition of the bank is based on the analysis of—

- management's plans as expressed by operating plans, the capital plan, and other projections,
- factors such as competition and economic conditions, and
- the overall present condition of the bank.

The primary information for evaluating the present condition of a bank is the findings and conclusions of the examination staff. The EIC should weigh the importance and significance of all criticisms, exceptions, and deficiencies in attempting to discover any unfavorable trends or situations. Through review of the examination process, insight can be gained into such central issues as—

- present asset quality;
- current liquidity position;
- present capital adequacy position;
- quality and performance of management, including the management of the bank's risk;
- earnings performance, both past and present; and
- sources and applications of funds.

The EIC usually will include remarks regarding those areas in the examination report. Although procedural areas of this manual deal specifically with each of those key items, the EIC should use information from all phases of the examination. For example, when reviewing the bank's present capital position, the EIC may use knowledge of the bank's asset and management quality to modify the conclusions of assisting personnel. The important point is that the EIC is in the best position to assess all information provided by the examination process.

Factors affecting the future condition of the bank can generally be categorized as internal or external. The examiner's review of the current condition flows naturally into an evaluation of internal factors affecting the institution's future prospects and condition. Among the items providing insight into future conditions are—

- earnings trends,
- successor-management plans,
- the budget or profit plan,
- the capital plan, and
- any other internally generated projections or forecasts.

Many banks will not have formal written plans or projections. In such cases, the EIC must obtain from senior management or the board of directors information on their plans for matters such as—

- growth and expansion,
- capital,
- changes in the size and mix of assets and liabilities, and
- changes in sources of funding.

In addition, examiners should remind senior management that any change in the general character of a bank's business or the scope of the corporate powers it exercises requires the prior approval of the Board under Regulation H.

The examiner should recommend that banks that do not have formal plans or projections take advantage of any externally available tools to aid them in formulating these plans. In today's competitive market, strategic planning is a necessity for almost all banks, but especially for banks that are losing their market share or in which inefficiencies are depressing profitability.

If banks prepare budgets or profit plans, insight can be gained into the accuracy of balance-sheet and earnings projections by comparing actual and projected account balances. It also is beneficial to compare original projections with current projections to determine that adjustments are made on a timely basis. When four- or five-year projections are made, banks often formulate several forecasts based on different sets of assumptions. In such a situation, the examiner should attempt to determine the bank's most likely future course.

The examiner should attempt to gain access to any official material or internal workpapers that document or illustrate the bank's rationale in planning its future. The goal is to review the institution's decision-making process.

Banks are increasingly engaging in off-balance- sheet activities to deliver services, effect payments, generate income, and to hedge interest-rate risks. Banks have introduced a wide variety of new products and services to complement their more traditional activities. Although these new activities are useful and profitable, they contain elements of risk. Many of these new activities involve a contingent liability or other risk that is not reflected on the bank's balance sheet and, indeed, may not even be fully recognized by the bank. The examiner should be aware of how the bank manages and controls its risks. Examples of off-balance-sheet activities include—

- guarantee contracts, retained or contingent interests, and variable interests,
- commitments and innovative applications for standby letters of credit, and
- a wide variety of financial instruments and investment-security activities (including futures and forwards, warrants, puts, and calls).

Risk can be distinguished primarily as credit risk, liquidity, market (price, interest rate, foreign exchange), operational, reputational, and legal risk. Risk can also result from internal control deficiencies. Examiners must also be aware of the nature and extent of off-balance-sheet risks. The risks that affect capital, liquidity, and compliance with laws should be evaluated for their potential effect on the safety and soundness of the bank.

In judging such controversial areas as capital adequacy and liquidity, the examiner should remember that, under ideal circumstances, management should be the expert on the bank's capitalization and liquidity position. Judgments on such matters should be generated internally, based on insight only management can possess. It is management that should know the bank's competitive situation, the economics of the service area, and the anticipated impact of those and other factors on its plans for growth and expansion. It is also management that has the greatest interest in the success of the bank. Accordingly, management and the directorate should choose a level of capitalization and liquidity consistent with their perception of the bank's situation rather than reacting to competitors or relying on pressures from regulators. However, specific judgments by the examiner are required, particularly in situations where a capital or liquidity position has fallen below what examiners consider to be acceptable norms. Objective justification for lower levels of capital or liquidity must be obtained and analyzed.

To properly evaluate the future prospects of a bank, the examiner must review external factors affecting the institution. Significant among those factors are the characteristics of a bank's primary service area. The bank's primary service area is defined as that area from which the bank receives approximately 75 percent of its deposits. Demographics of the area generally are available, and every bank should accumulate such information to aid in analyzing its current operations and planning for future operations. The absence of such information in an up-to-date form should be considered a deficiency. Included under examination procedures for this section is a listing of minimum information required to ascertain the demographics of a service area. The EIC should make sure that information is compiled and should analyze it to determine whether management expectations appear justifiable in the circumstances.

In dealing with competitive factors, the examiner should review or compute the share of market for the bank under examination. Continuing records in that area establish an analyzable trend. Consideration also should be given to changes in the bank's statutory and regulatory environment, such as—

- changes in branching laws,
- changes in tax structure, and
- changes in laws affecting competition with other financial institutions.

Once the examiner has reached specific conclusions about the present condition and future prospects of the bank, or has noted serious deficiencies or detrimental trends, his or her conclusions and suggestions should be communicated to the bank's senior management, the board of directors, and the Federal Reserve Bank on a timely basis. In formulating discussion and written comments, the examiner should avoid the appearance of second-guessing management. Therefore, conclusions, judgments, and recommendations should be based on objective information generated throughout the entire examination process.

Before preparing examination report comments regarding the overall condition of the bank, the EIC should consider the reporting objective. Once it is determined that problems exist in a bank, the underlying causes must be identified. Those underlying causes as well as specific problems or deficiencies should be covered in the comments. For example, if deficiencies in written lending objectives or policies or noncompliance with sound policies has resulted in the acquisition of sub-quality assets, the examiner's comments must address both cause and effect. The total of classified assets should be cited as evidence of the underlying problem, and appropriate remedies, such as changing objectives or policies, should be suggested.

Examiners should remember that their ability to reach accurate conclusions regarding the overall present condition and future prospects of the bank and their skill in communicating the conclusions to management orally and in reports will, to a great extent, determine the effectiveness of the entire examination process.

The examiner's conclusions regarding the overall condition of the bank are summarized in a composite rating assigned in accordance with guidelines provided under the Uniform Financial Institution Rating System (CAMELS). The composite rating represents an overall appraisal of six key assessment areas (components) covered under the CAMELS rating system: Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk. Additionally, and separate from the interagency UFIRS, the Federal Reserve assigns a Risk Management Rating to all state member banks. The summary, or composite, rating, as well as each of the assessment areas, including risk management, is delineated on a numerical scale of one to five, one being the highest or best possible score. Thus, a bank with a composite rating of one requires the lowest level of supervisory attention, while a five-rated bank has the most critically deficient level of performance and therefore requires the highest degree of supervisory attention. When appraising the six key assessment areas and assigning a composite rating, the examiner weighs and evaluates all relevant factors for downgrades and upgrades of supervisory ratings. (For more information regarding composite rating considerations, see SR-96-38, SR-95-51, SR-16-11, and the appendix section A.5020.1 and also SR-12-4 with regard to CAMELS rating upgrades.) In general, these factors include the adequacy of the capital base, net worth, and reserves for supporting present operations and future growth plans; the quality of loans, investments, and other assets; the ability to generate earnings to maintain public confidence, cover losses, and provide adequate security and return to depositors; the ability to manage liquidity and funding (in particular, during periods of increased financial stress); the ability to meet the community's legitimate needs for financial services and cover all maturing deposit obligations; and the ability of management to properly administer all aspects of the financial business and plan for future needs and changing circumstances. The assessment of management and administration includes the quality of internal controls, operating procedures, and all lending, investment and operating policies; compliance with relevant laws and regulations; and the involvement of the directors, shareholders, and officials.

In addition to the factors discussed above, the EIC should also consider whether risk-management capabilities have improved to address identified principal weaknesses that contributed to the institution's prior ratings, and whether any policies and practices had been implemented that focused on sustainability commensurate with the bank's risk profile. The EIC should also make a determination as to whether the board provided strategic review and oversight of the bank's core financial factors and risk management and if the board actively engaged in the process of correcting deficiencies.

Although the composite rating is based loosely on the average of the six component scores, the examiner's judgment can and should play a major role in its determination. Thus, the examiner must assess the severity, particularly the potential impact, of individual weaknesses on the present and future viability of the bank. Significant problems will provide sufficient basis for deviating from the numerical-average approach to assigning the composite rating. However, whenever deviation from the numerical standards for the composite rating is necessary to accurately reflect the overall condition of the bank, the examiner must provide a full explanation of the reasons for such deviation. See the appendix section A.5020.1 for a complete discussion of the uniform rating system and considerations to be taken into account when using it to evaluate the condition of a bank.

SUPERVISORY RATINGS UPGRADES

When in a period of stabilized or generally improving economic conditions, there may be some consideration given to ratings upgrades. (See SR-12-4 "Upgrades of Supervisory Ratings for Banking Organizations with $10 Billion or Less in Total Consolidated Assets.") (See also SR-96-38, SR-95-51, and SR-16-11.)

SUBSIDIARIES OF BANK HOLDING COMPANIES

The composite rating of an individual subsidiary bank should be based on the condition of that single entity. The quality of management and the financial condition of the consolidated organization will be useful in assessing the prospects and understanding the operations of the bank being examined. However, banks with weaknesses requiring corrective action should be identified as such. Then, appropriate supervisory focus can also be made at the consolidated level. Also, banks should be identified by type on an individual basis rather than by applying the consolidated organization's characteristic to each bank. For example, the capital and condition of a community bank should be judged by community bank standards, not by multinational or regional standards, even if the bank is owned by such an organization. This approach recognizes that two consolidated organizations of similar size may be composed of entirely different types of banks. Proper evaluation of each bank component should lead a bank holding company examiner to the most appropriate conclusion on the condition of the consolidated entity.

CONFIDENTIALITY OF THE SUPERVISORY RATING AND OTHER NONPUBLIC SUPERVISORY INFORMATION

A February 28, 2005, interagency advisory reminds banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to third parties. The agencies[1] learned that some insurers had requested or required banks and savings associations (financial institutions) to disclose their CAMELS rating during the underwriting process when those institutions had sought directors' and officers' liability (D&O) coverage.[2] The agencies responded by issuing the advisory specifically to remind all banking organizations that, except in very limited circumstances, they are prohibited by law from disclosing their CAMELS rating and other nonpublic confidential supervisory information to insurers as well as other nonrelated third parties without permission from their appropriate federal banking agency. (See SR-07-19, SR-05-4, and SR-96-26.)

Federal banking regulations provide that the report of examination, which contains the CAMELS rating, is nonpublic information and is the property of the agency issuing the report.[3] These regulations specifically provide that, except in very limited circumstances, banks and other financial institutions may not disclose a report of examination or any portion of the report, nor make any representations concerning the report or the report's findings, without the

1. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC).

2. As part of the examination process, a confidential supervisory rating, called a CAMELS rating, is assigned to each depository institution regulated by the agencies. See the appendix section A.5020.1 for a complete description of the Uniform Financial Institutions Rating System or CAMELS rating system.

3. For the Federal Reserve, see 12 CFR 261.2(c)(1), 261.20(g), and 261.22(e).

prior written permission of the appropriate federal banking agency.[4] The circumstances for release of nonpublic supervisory information may include disclosure to a parent holding company, a director, an officer, an attorney, an auditor, or another specified third party, as indicated in the regulations of the appropriate federal banking agency.[5] Any person who discloses or uses nonpublic information except as expressly permitted by one of the appropriate federal banking agencies or as provided by the agency's regulations may be subject to the criminal penalties provided in 18 USC 641.

The legal prohibition on the release of nonpublic supervisory information applies to all financial institutions supervised by the agencies, including bank, savings and loan, or other holding companies; Edge corporations; and the U.S. branches or agencies of foreign banking organizations, which receive confidential supervisory ratings, including the RFI/C(D) rating, ROCA rating, and CAMEO rating.[6] As with the CAMELS rating, these ratings are transmitted to the regulated institutions in reports of inspection or examination, which are the property of the agencies.

Financial institutions that receive requests for confidential supervisory ratings should refer all requesters to the following publicly available information in lieu of disclosing any confidential regulatory information, including the CAMELS rating. (See the National Information Center, on the Federal Financial Institutions Examination Council (FFIEC) website, https://www.ffiec.gov.)

- for banks, an institution's quarterly reports of condition and income (Call Reports) (see 12 USC 1817)
- for holding companies or foreign banks with U.S. operations, an institution's quarterly and annual FR Y or H-(b)11 reports (see 12 USC 1844, 3106, 3108, 601–604a, and 611–631)
- for national banks, the annual disclosure statement (see 12 CFR 18.3)
- for banks, the institution's Uniform Bank Performance Report (UBPR), which is available to all interested parties at the website https://www.ffiec.gov and is designed for summary and in-depth analysis of banks
- an institution's publicly available filings, if any, filed with the appropriate federal banking agency (15 USC 78(*l*)(i)) or with the U.S. Securities and Exchange Commission
- any reports or ratings on the institution compiled by private companies that track the performance of financial institutions[7]
- any reports or ratings issued by private rating services on public debt issued by an institution
- any publicly available cease-and-desist order or enforcement proceeding against an institution[8]
- any reports or other sources of information on institution performance or internal matters created by the institution that does not contain information prohibited from release by law or regulation

FORMAL AND INFORMAL SUPERVISORY ACTIONS

In general, supervisory action should be considered when other more routine measures, such as formal discussions with a bank's principals or directors and normal follow-up procedures, have failed to resolve supervisory concerns. The Uniform Financial Institution Rating System clearly identifies the more serious problem banks and distinguishes them from banks whose weaknesses or deficiencies are such as to warrant a lower degree of supervisory concern.

For example, the application of prompt and effective remedial action may keep the condition of a composite 3-rated bank from deteriorating and the bank from becoming a problem institu-

4. See 12 CFR 261.22.

5. See 12 USC 326 and 12 CFR 261.20(b) (exceptions).

6. RFI/C(D), ROCA, and CAMEO ratings are assigned by the FRB as a result of an examination or inspection. As of January 1, 2005, the FRB adopted a new rating system, RFI/C(D) ratings, for bank holding companies. RFI/C(D) ratings components are Risk management, Financial condition, potential Impact of the parent and nondepository subsidiaries on the subsidiary depository institutions, Composite, and Depository institution. For noncomplex bank holding companies with assets of $1 billion or less, only risk-management and composite ratings are assigned. ROCA ratings are assigned to the U.S. branches, agencies, and commercial lending companies of foreign banking organizations. The ROCA rating components are Risk management, Operational controls, Compliance, and Asset quality. CAMEO ratings are assigned to Edge corporations and the overseas branches and subsidiaries of U.S. banks. The CAMEO ratings components are Capital, Asset quality, Management, Earnings, and Operations and internal controls.

7. For bank rating services, see the guidance at https://www.fdic.gov/bank/index.html.

8. Information on enforcement actions taken by the Federal Reserve may be found on the Board's public website. Information on enforcement actions taken by other federal agencies, such as the Securities and Exchange Commission, the Financial Crimes Enforcement Network (FinCEN), and the Department of Justice, as well as foreign authorities, may also be publicly available.

tion. To ensure problem areas receive adequate attention, all weaknesses should be clearly defined and corrective measures should be properly structured. This objective may best be achieved through the execution of a memorandum of understanding (MOU) between the bank's board of directors and Reserve Bank officials. In instances where there are only a few minor issues, an informal action such as a commitment letter or a board resolution could be issued. A MOU is not a formal written agreement as prescribed in the Financial Institutions Supervisory Act of 1966 (as amended); it is a good faith understanding between the bank's directorate and the Reserve Bank concerning the principal problems and the bank's proposed remedies. MOUs, commitment letters, and, i.e., Board resolutions, are all normal actions.

Banks rated composite 4 or 5 are clearly problem institutions that require close and constant supervisory attention. Unless specific circumstances argue strongly to the contrary, such banks will be presumed to warrant formal supervisory action, that is, a written agreement or a cease-and-desist order, as provided for in the Financial Institutions Supervisory Act of 1966. In addition, the Board of Governors is authorized to suspend and remove offending officers and directors of banks for certain violations and activities.

Although the decision to pursue formal or informal supervisory actions belongs to the Board of Governors or the Reserve Bank, the initial consideration and determination of whether action is necessary usually results from the examination process. Accurate and complete examination report comments that carefully delineate both the bank's weaknesses and deficiencies, as well as management's existing or planned corrective measures, will allow the Reserve Bank to make the most informed decision concerning appropriate supervisory action In addition to the results of the examination process leading to an enforcement action, sometimes an enforcement action is the result of an investigation or reporting of a violation of law or regulation.

CIVIL MONEY PENALTIES

Under provisions of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95–630), the Board of Governors is authorized to assess civil money penalties for violation of the terms of a final cease-and-desist order and violations of—

- sections 19, 22, and 23A of the Federal Reserve Act (respectively, reserve requirements and interest-rate limitations; limitations on loans by insured banks to their executive officers, directors, and principal shareholders; and limits on loans by insured banks to their affiliates);
- the prohibitions of title VIII of FIRA against preferential lending to bank executive officers, directors, and principal shareholders based on a correspondent-account relationship; and
- a willful violation of the change in Bank Control Act of 1978 (12 USC 1817(j)).

In determining the appropriateness of initiating a civil money penalty assessment proceeding, the Board has identified a number of relevant factors (see the June 3, 1998, FFIEC "Interagency Policy Regarding Assessment of Civil Money Penalties" found in the *Federal Reserve Regulatory Service*, 3–1605). In assessing a civil money penalty, the Board is required to consider the size of the financial resources and good faith of the respondent, the gravity of the violation, the history of previous violations, and such other matters as justice may require.

Examiners are responsible for the initial analyses on potential civil money penalties. Civil money penalties should be proposed for serious violations and for violations which, because of their frequency or recurring nature, show a general disregard for the law. After the examiner has reviewed the facts and decided to recommend a civil money penalty, he or she should contact the Reserve Bank for advice on proper documentation and any other assistance.

Overall Conclusions Regarding Condition of the Bank

Examination Objectives

Effective date March 1984

Section 1100.2

1. To reach conclusions regarding the present condition of the bank.
2. To reach conclusions regarding the future prospects of the bank.
3. To determine the bank's ability to meet demands in the ordinary course of business or reasonably unusual circumstances.
4. To determine the bank's adherence to safe and sound banking practices.
5. To formulate recommended action, when appropriate, based on those conclusions.
6. To communicate conclusions and recommendations both orally and in the examination report.

Inasmuch as the following procedures are largely dependent on information generated from all phases of the examination, the examiner-in-charge should complete this program during the final stages of the examination. The completion of this program generally can be best accomplished during the review of the workpapers.

1. Analyze any available information concerning the characteristics of the area in which the bank operates to determine the existence of any unusual situations, any significant trends, the potential impact on the bank of any expected changes or any other significant information which could be detrimental to the bank. The bank should be consulted for sources of information which might include the most recent census data or data generated by organizations, such as the Chamber of Commerce. In analyzing the bank's trade area:
   a. Consider density, income levels, general age group of the residents. Determine if there are significant changes in any of the above factors.
   b. Determine the predominant living accommodations in the area (owner occupied vs. rental), price/rent levels and availability of residential units. Determine whether there are any major residential construction projects, re-zoning or conversions of single to multiple units which will have a significant effect on the bank.
   c. Consider the types of industry and the number of firms in the area with emphasis on determining concentrations or seasonality. Investigate any major labor contract expirations, competitive factors or other significant factors which could have a negative effect on the community.
   d. Consider the types of major products, available markets and present and projected prices for the products.
   e. Consider any expected changes in street facilities which will significantly affect bank's accessibility/convenience. Determine the availability of public transportation.
   f. Review the number and types of institutions that provide similar financial services in the community. Consider the aggressiveness, hours of business and additional services offered by competitor institutions.
   g. Determine the effect of government employment or dependence on government contracts on the community.
   h. Consider the condition of the national economy with particular attention to the rate of inflation, national vs. local unemployment, current interest rates and government fiscal and monetary policy. Specific problems, peculiar to a particular area should be investigated more thoroughly.
2. Review comments and conclusions contained in the workpapers which were generated throughout the examination and perform the following:
   a. Compile all criticisms, exceptions and deficiencies.
   b. Determine the existence of contradictory conclusions.
   c. Consider the relative significance of criticisms, exceptions, deficiencies and conclusions and segregate important criticisms for the final review with management and for incorporation into the report of examination.
3. Based on procedures performed and conclusions contained in the workpapers, answer the following specific questions. These questions are intended as guidelines to the examiner-in-charge in formulating overall conclusions regarding the condition of the bank and should be augmented by the examiner's knowledge of the bank. "Yes" answers, in many instances, evidence the existence of a "leading" indicator of deterioration of bank soundness. For any question with a "yes" answer, specify any mitigating circumstances in the comments column. Sub-question answers are for information purposes.

   a. *Asset Quality*

      - Is there an increasing ratio of criticized assets to total capital?

- — If so, is it indicative of adverse economic conditions, poor credit judgment, or other factors (specify)?
- Has there been a material increase in the quantity of non-earning assets?
- Is there any abnormally increasing trend of past-due loans and/or interest earned but not collected?
  - — If so, is it indicative of general economic conditions in the bank's trade area
  - — Is the trend indicative of a weakening of collection policies and procedures, a slackening of credit standards, the bank's failure to recognize an asset which should be in a non-earning category, or is it caused by some other factor?
- Has a trend developed wherein the bank assumes increased risk without receiving increased rewards?
- Do the portfolios exhibit high concentrations in specific industries?
  - — If so, do the concentrations represent a significant actual or contingent problem?
- Has the overall quality of assets deteriorated since the last examination?
  - — If so, is the deterioration recognized by management and the board of directors? Can the deterioration be attributed to factors beyond the control of management or the board of directors, such as a change in the general economic conditions of the bank's service area?
  - — If deterioration results from internal factors, such as lowering of credit standards or poor credit judgment, have steps been taken by management to effectively reverse negative trends?

b. *Quality of Management*

- Has the executive management changed since the last examination?
  - — If so, is the change detrimental to the bank?
- Has there been any change in the general banking philosophy of executive management?
  - — If so, is that detrimental to the bank?
- Do key bank officers have educational and/or experience levels below that considered minimal in the circumstances?
- Is there any tendency toward over reliance on essentially untrained and unskilled clerical staffs?
- Is there a large disparity between the compensation level of the chief executive officer and other members of executive management?
  - — If so, is that disparity an objective indication of disproportional domination of the bank's affairs?
- Has the bank instituted any systems which directly reward managers for increasing bank income from assets or services subject to their control?
  - — If so, has the bank failed to institute necessary control and audit procedures to prevent abuses?
- Has the bank failed to institute any programs which would give officers a vested interest in remaining with the bank?
  - — If so, would the institution of such a program offer a workable solution to an actual or potential officer turnover problem?
- Is the bank's strategic and operational planning inadequate?
- Is the board of directors unresponsive to internal or external suggestions for improvement in the bank?
- Are the following conditions present?
  - — Infrequent meetings of board of directors.
  - — Infrequent meetings of committees of the board.
  - — Infrequent management committee meetings.
  - — A directorate which is split into distinct voting groups.
  - — If so, are directors viewed as failing to perform their functions adequately?
- Is the quality of management deemed inadequate to conduct the affairs of the bank in a reasonable and safe manner?
- Are training programs and compensation increments deemed inadequate to attract and retain a staff capable of providing management succession?

c. *Earnings*

- Are earnings static or moving downward as a percentage of total resources?
- Is there a trend of decreasing income before security gains and losses as a percentage of total revenues?
  - — If so, is such a trend expected to continue?
  - — If so, has management determined causes for any deterioration and taken action to reverse the negative trend?
- Has the ratio of operating expenses to operating revenues been increasing?
- Are earnings trends consistent?
- Has a decreasing spread between interest earned and interest paid developed?
- Are the bank's earnings significantly vulnerable to changes in interest rate levels?
  - — If so, what are management's plans and prospects for altering the vulnerability?
- Are there any significant structural changes in the balance sheet which may impact earnings?
- Has the bank experienced increasing actual loan losses and/or loan loss provisions?
- Is there any evidence that sources of interest and other revenues have changed since that last examination?
  - — If so, is that attributed to an unsound emphasis for increased earnings?
- Are earnings deemed inadequate to provide increased capitalization commensurate with the bank's growth?

d. *Capital*

- Has the bank been unable to maintain a normal growth rate for capital?
- Do the ratios of loans to capital, deposits to capital or total assets to capital exhibit a trend to abnormal increases?
- Is capital deemed inadequate to support the present volume of business, including the volume of off-balance-sheet activities, in view of the amount of criticized assets, the competency of management, etc.?

e. *Liquidity*

- Is there a trend toward decreasing bank liquidity?
- Has the bank been forced to increase abnormally dependence on borrowed funds to support existing assets?
- Does the bank depend excessively on purchased funds?
- Is there a trend toward investing interest sensitive liabilities in non-interest sensitive assets?
- Do the present quantity and maturity of non-interest sensitive assets represent a dangerous or potentially dangerous situation?

f. *Off-Balance-Sheet Risk*

Loans Sold or Serviced

- Is the bank involved as the lead or agent in loan participations, syndications, or servicing activities to the extent that management expertise is inadequate, or to the extent that the volume exceeds the level which management can capably handle?
- Does the bank's record of pending or threatened litigation indicate any instances where the bank, as lead or agent in a loan participation or syndication, has willfully misrepresented the credit to the other participants, or otherwise acted with gross negligence in handling the credit?
  - — If so, is there any indication that the participants intend to hold the bank liable for any loss incurred on the credit?
- Did the examination reveal a practice of improper origination and packaging of loans sold or serviced which could cause:
  - — The bank being compelled to repurchase the package, or
  - — In the case of government guaranteed loans, the complete or partial dishonor of the guaranty?
- Has the bank previously repurchased participations when a loss was incurred, although it was not legally required to do so?

Letters of Credit

- Is there a trend toward increasing the issuance of standby letters of credit or other similar credit instruments?
  - If so, has the bank failed to consider the full impact of funding a significant percentage of those instruments?
- Are letters of credit excluded from the bank's internal loan review program?
- Does the internal evaluation of letters of credit include consideration of country and currency risk as well as credit risk?
- Is there a declining trend in the credit quality of letters of credit?
- Are standby letters of credit issued for purposes not covered in the bank's lending policy, or for which management does not have the expertise to handle?
- If not authorized in the bank's lending policy, were proper approvals obtained prior to issuance?

Wire Transfer Department

- Do internal control deficiencies in the wire transfer department pose a threat for large potential losses through fraud or error?
- Are there internal control deficiencies in the receiving and conveying of messages for other parties which may expose the bank to litigation for improper handling of the messages?

Data Processing Department

- Are internal controls inadequate in the bank's data processing area?
  - Are control deficiencies such that the accuracy and/or timeliness of data is questionable?
  - Are deficiencies such that the bank, in performing data processing services for others, could be liable for misplacement or other improper handling of source data?
- Are the bank's computer hardware and software systems inadequate to support the present and anticipated level of operations?
  - Are deficiencies such that hardware and systems will require replacement or upgrading in the short term?

Settlement Procedures

- If the bank is a member of CHIPS, Fedwire or other clearinghouse system, are procedures inadequate for the proper monitoring of incoming and outgoing wire transfers so that the bank is occasionally unprepared for settlement?
  - Would earnings be significantly affected if the immediate acquisition of funds is required to meet settlement?
  - Is the bank aware of the creditworthiness and ability of the other clearinghouse participants to make settlement?
- Are customers' daylight overdrafts allowed to exceed established credit limits or are they otherwise being improperly monitored?
- Is there a history of daylight overdrafts which have not been covered before the close of business?

Investment Securities

- Are there significant internal control deficiencies associated with the bank's handling of "when issued" trades, futures contracts and forward placements?
  - Is management's knowledge of interest rate hedging techniques insufficient to support such activity?
- Does the bank act as agent on securities or repurchase agreement transactions?
  - If so, does the customer agreement specifically designate liability for failure or performance?

Miscellaneous

- Did the analytical review of income and expenses disclose any additional off balance sheet activities for which management does not exhibit the necessary expertise and does not have

adequate internal controls to handle the service?
- Does a review of legal actions against the bank indicate any pattern of practices which are caused by deficient internal controls?
  — If so, have the deficiencies been corrected?
- Is the potential liability arising from pending litigation considered significant in terms of capital adequacy and liquidity, considering the level of other contingent liabilities?
- Are any of the bank's affiliates or subsidiaries experiencing unprofitability or liquidity problems which may affect the soundness of the bank?
- Are operating lease liabilities and annual lease payments significant in terms of the bank's other funding requirements?
- Is potential restitution resulting from Truth in Lending Act violations significant relative to capital and liquidity?
- Is the bank's level of loan commitments, standby letters of credit, commitments to purchase securities and futures/forward contracts imprudent in light of overall circumstances within the bank?

g. *Internal Controls and Audit Procedures*

- Have internal controls deteriorated since the last examination?
- Do any of the following exist at the bank?
  — Low compensation level of internal auditors.
  — Internal or external auditor who reports directly to other than the board of directors or a committee thereof.
  — Internal auditors who perform original work versus monitoring the efforts of others.
  — Abnormally low percentage of internal auditors to total personnel.
  — Inadequate training or supervision of internal auditors.
  — Questionable independence of external auditors.
  — Inadequate management response to deficiencies cited by auditors.

  If so, do these or other pertinent factors indicate a less than adequate situation in internal or external audit?
- Are internal controls and audit programs deemed inadequate?

h. *Ownership*

- Have there been significant changes in ownership since the last examination?
  — If so, could the change be detrimental to the soundness of the bank?
- Does any situation exist wherein one individual is capable of controlling the bank?
  — If so, is that detrimental to the bank's soundness?
- Is there any evidence of an impending proxy fight?
- Are ownership interests using borrowed funds to carry the bank's stock?
  — If so, is there an indication that undue pressure for increased earnings is being applied by the owners?
  — If such pressure is being applied, does that have a detrimental impact on the general characteristics of asset composition, as it exists, and asset composition, as it is expected to develop?

i. *Miscellaneous*

- Does the bank exhibit a high dependence on purchasing or participating in loans originated and managed by others?
  — If so, is that attributable to a lack of local loan demand or to a failure of the bank to service its trade area?
- Is there an increasing trend toward making loans and/or accepting deposits from outside of areas in which the bank maintains offices?
  — If so, does management and the board fully understand the risks inherent in such activity?
- Has a trend toward increasing advances to affiliated companies developed?

  - — If so, does that presently represent a dangerous situation?
- Has the bank experienced an abnormally fast rate of growth?
  - — If so, is that growth reasonable and does it therefore, have no significant impact on future soundness, based on:
    - Economic conditions within the trade area?
    - The bank's increased marketing efforts?
    - Offering improved services to the community?
    - Other factors?
  - — If so, is the bank's management team capable of adequately administering the growth?
- Does the bank have an imprudent investment in fixed assets?
- Does the bank depend to an excessive degree on a small, local economy, which is subject to cyclical swings due to local conditions and industries, as opposed to mirroring national economic trends?
  - — If so, is that a source of criticism or does it represent a potentially dangerous situation?
- Are there large fluctuations in the stock price of the bank or its parent?
  - — If so, is management unable to discern a cause for such fluctuations?
- Is management giving inadequate attention to compliance with laws and regulations?

4. Have all questions raised by the UBPR specialist been explored?
5. Complete workpapers.
6. Organize general conclusions regarding the present condition of the bank and:
   a. Correlate plans, projections, forecasts, and budgets with present conditional aspects, area characteristics, and management capability to determine which of the goals the bank has set you believe to be unattainable.
   b. Project the future condition of the bank based on its present financial condition, the economic expectations of the bank, the quality of management, director supervision and any other relevant factors.
   c. Formulate recommendations for management to consider when they initiate corrective or preventative action.
7. Conduct a final summary discussion with management to include:
   a. Criticisms noted during the examination.
   b. Conclusions reached about the bank in general.
   c. Expected future condition:
      - Management's view.
      - Examiner's view.
   d. Review of other potential problems.
   e. Planned corrective action:
      - Examiner recommendations.
      - Management commitments.
8. Update "Management Assessment" conclusion to add any relevant information obtained as a result of procedures performed in this program.
9. Prepare recommendations for any necessary supervisory action.
10. Perform the following steps for suspected violations of criminal statutes:
    a. Determine that a Criminal Referral Form, FR 2230, has been filed, if appropriate.
    b. Notify the Reserve Bank by telephone immediately if warranted by the type and seriousness of the suspected violation.
    c. Prepare a separate memorandum to the Reserve Bank containing sufficient detail to be fully informative.
    d. Prepare brief comments for the confidential section of the report of examination citing the date of the memorandum to the Reserve Bank.
    e. Segregate, identify, initial and date all appropriate workpapers and transmit them to the Reserve Bank making certain that the workpapers are factual, complete and do not contain expressions of examiner opinion.
11. Write, in appropriate report form, all comments and conclusions to be included in the confidential section of the examination report.
12. Update the workpapers with any information that will facilitate future examinations.

OVERVIEW

Since 1979, state member banks have been rated using the interagency Uniform Financial Institutions Ratings System (UFIRS), which was recommended by the Federal Reserve and other banking agencies. This rating system, referred to industry-wide by the acronym CAMEL, evaluated five components: capital adequacy, asset quality, management and administration, earnings, and liquidity.

Over the years, the UFIRS has proven to be an effective internal supervisory tool for uniformly evaluating the soundness of financial institutions and for identifying those institutions requiring special attention or concern. The UFIRS was revised and updated to address changes in the financial services industry and in supervisory policies and procedures. The revisions include the addition of a sixth component addressing sensitivity to market risks, explicit reference to the quality of risk-management processes in the management component, and identification of risk elements within the composite and component rating descriptions.[1]

The revisions to UFIRS are not intended to add to the regulatory burden of institutions nor require additional policies or processes. Instead, they are intended to promote and complement efficient examination processes. The revisions have been made to update the rating system, while retaining the basic framework of the original system.

The UFIRS considers certain financial, managerial, and compliance factors that are common to all institutions. Under this system, the supervisory agencies endeavor to ensure that all financial institutions are evaluated comprehensively and uniformly and that supervisory attention is appropriately focused on the financial institutions exhibiting financial and operational weaknesses or adverse trends.

The UFIRS is a useful vehicle for identifying problem or deteriorating financial institutions, as well as for categorizing institutions with deficiencies in particular component areas. Further, the rating system helps Congress follow safety-and-soundness trends and assess the aggregate strength and soundness of the financial industry, which helps the federal banking agencies in fulfilling their collective mission of maintaining stability and public confidence in the nation's financial system.

1. See 61 Fed. Reg. 67,021 (Dec. 19, 1996) and SR-96-38, "Uniform Financial Institutions Rating System."

COMPOSITE RATINGS

Under the UFIRS, each financial institution is assigned a composite rating based on an evaluation and rating of six essential components of its financial condition and operations. These component factors address the adequacy of capital, quality of assets, capability of management, quality and level of earnings, adequacy of liquidity, and sensitivity to market risk. Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

Composite and component ratings are assigned based on a 1-to-5 numerical scale. A "1" is the highest rating, indicating the strongest performance and risk-management practices and the least degree of supervisory concern. A "5" is the lowest rating, indicating the weakest performance, inadequate risk-management practices, and the highest degree of supervisory concern.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up that component and its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, assignment of a composite rating may incorporate any factor that bears significantly on the overall condition and soundness of the financial institution. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

The ability of management to respond to changing circumstances and address the risks that may arise from changing business conditions or the initiation of new activities or products is an important factor in evaluating a financial institution's overall risk profile, as well as the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

Furthermore, the ability of management to identify, measure, monitor, and control the risks of its operations is taken into account when assigning each component rating. Examiners should recognize, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk-taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Examiners consider foreign branch and specialty examination findings and the ratings assigned to those areas, as appropriate, when assigning component and composite ratings under UFIRS. The specialty examination areas include Compliance, Community Reinvestment, Government Security Dealers, Information Systems, Municipal Security Dealers, Transfer Agent, and Trust.

Composite ratings are based on a careful evaluation of an institution's managerial, operational, financial, and compliance performance. The six key components used to assess an institution's financial condition and operations are capital adequacy, asset quality, management capability, earnings quantity and quality, the adequacy of liquidity, and sensitivity to market risk. The rating scale ranges from 1 to 5, with a rating of 1 indicating the strongest performance and risk-management practices, relative to the institution's size, complexity, and risk profile, and the level of least supervisory concern. A rating of 5 indicates the most critically deficient level of performance; inadequate risk-management practices relative to the institution's size, complexity, and risk profile; and the level of greatest supervisory concern. The composite ratings are defined below.

Composite 1

Financial institutions with a composite 1 rating are sound in every respect and generally have components rated 1 or 2. Any identified weaknesses are minor and can be handled routinely by the board of directors and management. These financial institutions are the most capable of withstanding fluctuating business conditions and are resistant to outside influences, such as economic instability in their trade area. These institutions are in substantial compliance with laws and regulations. As a result, they exhibit the strongest performance and risk-management practices relative to their size, complexity, and risk profile, and give no cause for supervisory concern.

Composite 2

Financial institutions with a composite 2 rating are fundamentally sound. For a financial institution to receive this rating, generally none of its component ratings should be more severe than 3. Only moderate weaknesses are present, and the board of directors and management are capable of and willing to correct them. These financial institutions are stable, can withstand business fluctuations, and are in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Financial institutions with a composite 3 rating exhibit some degree of supervisory concern in one or more of the component areas. These institutions have a combination of moderate to severe weaknesses; however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate timeframes. Financial institutions in this group generally are less capable of withstanding business fluctuations and are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these financial institutions may be in significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. These financial institutions require more than normal supervision, which may include formal or informal enforcement actions. Failure of the institution appears unlikely, however, given its overall strength and financial capacity.

Composite 4

Financial institutions with a composite 4 rating generally exhibit unsafe and unsound practices or conditions. They have serious financial or managerial deficiencies that result in unsatisfactory performance. The institution's problems range from severe to critically deficient, and weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. Financial institutions in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the institution's size, complexity, and risk profile. Close supervisory attention is required, which means formal enforcement action is necessary in most cases to address the problems. Institutions in this group pose a risk to the deposit insurance fund. Failure of the institution is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5

Financial institutions with a composite 5 rating exhibit extremely unsafe and unsound practices or conditions. Their performance is critically deficient and risk-management practices are inadequate relative to the institution's size, complexity, and risk profile. These institutions are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed for the financial institution to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and their failure is highly probable.

COMPONENT RATINGS

Each of the component rating descriptions below lists the principal evaluation factors that relate to that component and briefly describes each numerical rating for that component. Some of the evaluation factors appear under one or more of the other components to illustrate the interrelationship among the components. The evaluation factors for each component are not listed in any particular order.

Capital Adequacy

A financial institution is expected to maintain capital commensurate with its risks and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the need to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences of these risks on the institution's capital.

The capital adequacy of an institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of capital and the overall financial condition of the institution
- 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 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 past experience in managing growth
- access to capital markets and other sources of capital, including support provided by a parent holding company

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 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. The institution's viability is threatened, and immediate assistance from shareholders or other external sources of financial support is required.

Asset Quality

The asset-quality rating reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, other assets, and off-balance-sheet transactions. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the allowance for loan and lease losses and weigh the institution's exposure to counterparty, issuer, or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including but not limited to operating, market, reputation, strategic, or compliance risks, should be considered.

The asset quality of a financial institution is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of underwriting standards, soundness of credit-administration practices, and appropriateness of risk-identification practices
- the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance-sheet transactions
- the adequacy of the allowance for loan and lease losses and other asset valuation reserves
- the credit risk arising from or reduced by off-balance-sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit
- the diversification and quality of the loan and investment portfolios
- the extent of securities underwriting activities and exposure to counterparties in trading activities
- the existence of asset concentrations
- the adequacy of loan and investment policies, procedures, and practices
- the ability of management to properly administer its assets, including the timely identification and collection of problem assets
- the adequacy of internal controls and management information systems
- the volume and nature of credit-documentation exceptions

Ratings

1—A rating of 1 indicates strong asset-quality and credit-administration practices. Identified weaknesses are minor and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is of minimal supervisory concern.

2—A rating of 2 indicates satisfactory asset-quality and credit-administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.

3—A rating of 3 is assigned when asset-quality or credit-administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality or an increase in risk exposure. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern. There is generally a need to improve credit-administration and risk-management practices.

4—A rating of 4 is assigned to financial institutions with deficient asset-quality or credit-administration practices. The levels of risk and problem assets are significant and inadequately controlled, and they subject the financial institution to potential losses that, if left unchecked, may threaten its viability.

5—A rating of 5 represents critically deficient asset-quality or credit-administration practices that present an imminent threat to the institution's viability.

Management

The capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's activities, and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Senior management is responsible for developing and implementing policies, procedures, and practices that translate the board's goals, objectives, and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability in relation to all aspects of banking operations as well as other financial-service activities the institution is involved in.

The capability and performance of management and the board of directors is rated based on, but not limited to, an assessment of the following evaluation factors:

- the level and quality of oversight and support of all institution activities by the board of directors and management
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the initiation of new activities or products
- the adequacy of and conformance with appropriate internal policies and controls addressing the operations and risks of significant activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and risk profile
- the adequacy of audits and internal controls to promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations, and internal policies
- compliance with laws and regulations
- responsiveness to recommendations from auditors and supervisory authorities
- management depth and succession
- the extent that the board of directors and management are affected by or susceptible to dominant influence or concentration of authority
- reasonableness of compensation policies and avoidance of self-dealing
- demonstrated willingness to serve the legitimate banking needs of the community
- the overall performance of the institution and its risk profile

Ratings

1—A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

2—A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the institution's size, complexity, and risk profile. Minor weaknesses may exist, but they are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

3—A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be insufficient for the type, size, or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

4—A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.

5—A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Earnings

The earnings rating reflects not only the quantity and trend of earnings, but also factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses. High levels of market risk may unduly expose the institution's earnings to volatility in interest rates. The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inability to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

The rating of an institution's earnings is based on, but not limited to, an assessment of the following evaluation factors:

- the level of earnings, including trends and stability
- the ability to provide for adequate capital through retained earnings
- the quality and sources of earnings
- the level of expenses in relation to operations
- the adequacy of the budgeting systems, forecasting processes, and management information systems in general
- the adequacy of provisions to maintain the allowance for loan and lease losses and other valuation allowance accounts
- the exposure of earnings to market risk such as interest-rate, foreign-exchange, and price risks

Ratings

1—A rating of 1 indicates earnings that are strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings.

2—A rating of 2 indicates earnings that are satisfactory. Earnings are sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity, and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.

3—A rating of 3 indicates earnings that need to be improved. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earnings.

4—A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. These institutions may be characterized by erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years.

5—A rating of 5 indicates earnings that are critically deficient. A financial institution with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

Liquidity

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and contingency funding plans

Ratings

1—A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.

2—A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.

3—A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may show significant weaknesses in funds-management practices.

4—A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.

5—A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Sensitivity to Market Risk

The sensitivity to market risk component reflects the degree to which changes in interest rates, foreign-exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or economic capital. When evaluating this component, consideration should be given to management's ability to identify, measure, monitor, and control market risk; the institution's size; the nature and complexity of its activities; and the adequacy of its capital and earnings in relation to the level of market-risk exposure.

For many institutions, the primary source of market risk arises from nontrading positions and their sensitivity to changes in interest rates. In some larger institutions, foreign operations can be a significant source of market risk. For other institutions, trading activities are a major source of market risk.

Market risk is rated based on, but not limited to, an assessment of the following evaluation factors:

- the sensitivity of the financial institution's earnings or the economic value of its capital to adverse changes in interest rates, foreign-exchange rates, commodity prices, or equity prices
- the ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile
- the nature and complexity of interest-rate risk exposure arising from nontrading positions
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations

Ratings

1—A rating of 1 indicates that market-risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of market risk taken by the institution.

2—A rating of 2 indicates that market-risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of market risk taken by the institution.

3—A rating of 3 indicates that control of market-risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital may not adequately support the degree of market risk taken by the institution.

4—A rating of 4 indicates that control of market-risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of market risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of market risk taken by the institution.

5—A rating of 5 indicates that control of market-risk sensitivity is unacceptable or that the level of market risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of market risk accepted by the institution.

Risk Management Rating

The Federal Reserve instituted an explicit risk management rating to be assigned for examinations and inspections commencing on or after January 2, 1996. The risk management rating applies to all state member banks, regardless of their size.[2]

The rating for risk management is based on a scale of one through five in ascending order of supervisory concern. Examiners should assign this rating to reflect findings within all four elements of sound risk management described above. The risk management rating should be reflected in the overall "Management" rating of the institution and should be consistent with the following criteria:

1—(Strong). A rating of 1 indicates that management effectively identifies and controls all major types of risk posed by the institution's activities, including those from new products and changing market conditions. The board and management are active participants in overseeing and managing risk, respectively, and ensure that significant policies and limits exist, and the board understands, reviews, and approves them. Policies and limits are supported by risk monitoring procedures, reports, and management information systems that provide management and the board with the necessary information and analysis to make timely and appropriate responses to changing conditions.

Internal controls and audit procedures are sufficiently comprehensive and appropriate to the size and activities of the institution. There are few noted exceptions to the institution's established policies and procedures, and none is material. Management effectively and accurately monitors the condition of the institution consistent with standards of safety and soundness and in accordance with internal and supervisory policies and practices. Risk management is considered fully effective to identify, monitor, and control risks to the institution.

2—(Satisfactory). A rating of 2 indicates that the institution's management of risk is largely effective, but lacking to some modest degree. It reflects a responsiveness and ability to cope successfully with existing and foreseeable exposures that may arise in carrying out the institution's business plan. While the institution may have some minor risk management weaknesses, these problems have been recognized and are being addressed. Overall, board and senior management oversight, policies and limits, risk monitoring procedures, reports, and management information systems are considered satisfactory and effective in maintaining a safe and sound institution. Generally, risks are being controlled in a manner that does not require additional or more than normal supervisory attention.

Internal controls may display modest weaknesses or deficiencies, but they are correctable in the normal course of business. The examiner may have recommendations for improvement, but the weaknesses noted should not have a significant effect on the safety and soundness of the institution.

3—(Fair). A rating of 3 signifies risk management practices that are lacking in some important ways and, therefore, are a cause for more than normal supervisory attention. One or more of the four elements of sound risk management are considered fair, and have precluded the institution from fully addressing a significant risk to its operations. Certain risk management practices are in need of improvement to ensure that management and the board, in their respective roles, are able to identify, monitor, and control adequately all significant risks to the institution. Weaknesses may include continued control exceptions or failures to adhere to written policies and procedures that could have adverse effects on the institution.

The internal control system may be lacking in some important respects, particularly as indicated by continued control exceptions or by the

1. This rating was introduced by SR-95-51, "Rating the Adequacy of Risk Management and Internal Controls at State Member Banks and Bank Holding Companies."

failure to adhere to written policies and procedures. The risks associated with the internal control system could have adverse effects on the safety and soundness of the institution if corrective actions are not taken by management.

4—(Marginal). A rating of 4 represents marginal risk management practices that generally fail to identify, monitor, and control significant risk exposures in many material respects. Generally, such a situation reflects a lack of adequate guidance and supervision by management or oversight by the board. One or more of the four elements of sound risk management are considered marginal and require immediate and concerted corrective action by the board and management. A number of significant risks to the institution have not been adequately addressed, and the risk management deficiencies warrant a high degree of supervisory attention.

The institution may have serious identified weaknesses, such as an inadequate separation of duties, that require substantial improvement in its internal control or accounting procedures or in its ability to adhere to supervisory standards or requirements. Unless properly addressed, these conditions may result in unreliable financial records or reports or operating losses that could seriously affect the safety and soundness of the institution.

5—(Unsatisfactory). A rating of 5 indicates a critical absence of effective risk management practices to identify, monitor, or control significant risk exposures. One or more of the four elements of sound risk management are considered wholly deficient and management and the board have not demonstrated the capability to address deficiencies.

Internal controls may be sufficiently weak as to jeopardize seriously the continued viability of the institution. If not already evident, there is an immediate concern as to the reliability of accounting records and regulatory reports and about potential losses that could result if corrective measures are not taken immediately. Deficiencies in the institution's risk management procedures and internal controls require immediate and close supervisory attention.

2000—ASSETS

The 2000 series of sections cover various themes related to a bank's assets. The sections explain the Federal Reserve's approach in assessing the loan portfolio management practices at a state member bank as well as the supervisory assessment of a bank's asset quality. There are sections that provide background information on the different lending activities that are common among state member banks and on a bank's off-balance-sheet and investment activities.

A statistically based sampling approach to loan reviews can serve as an alternative to the traditional ‘‘top-down’’ loan-coverage approach when scoping certain bank examinations. In some cases, sampling requires fewer loans[1] to be reviewed than would be required using the minimum-coverage approach, while in other cases it requires more. The results depend heavily on the number of commercial and industrial loans (C&I) and commercial real estate (CRE) loans and the structure of the loan portfolio. Asset size and the level of tier 1 capital also affect the sample methodology. Additionally, sampling may require fewer loans to be reviewed than under the traditional method in well-managed institutions whose portfolios are not dominated by a small number of relatively large exposures.

Significantly, sampling may provide examiners with a broader perspective on the accuracy of the bank’s classification process than is typically provided by the traditional minimum-coverage target approach. The sampling approach should be directed towards banks currently having a CAMELS composite and asset-quality rating of 1 or 2 and also assets of $10 billion or less. (See section 2086.1.) The statistical sampling approach is not recommended, however, for use at de novo banks or other banks with unusually high or low capital ratios. Reserve Banks wishing to experiment with the sampling program at organizations with CAMELS or asset-quality ratings of 3 or above or at larger organizations should contact Board staff so that the examiner’s experience that is gained in this area may be used to develop alternative sampling procedures for these other types of institutions.

See this manual’s section 2084.1 for the examiner loan-sampling requirements for state member bank and credit-extending nonbank subsidiaries of banking organizations with $10–$50 billion in total consolidated assets.

1. The term ‘‘loans’’ encompasses all sources of credit exposure arising from loans and leases, including guarantees, letters of credit, and other loan commitments. The sampling methods described in this section select ‘‘loans’’ for review by obligor or related group of obligors (where identifiable). Thus, in the sampling procedures, the term ‘‘loan’’ refers to total credit exposure to an individual obligor or related group of obligors. As this implies, loan amounts referred to in this section should be determined on an exposure basis, including all outstanding notes and commitments.

CONCEPT AND STRUCTURE OF THE SAMPLING TECHNIQUE

The sampling approach builds on procedures examiners currently use to evaluate loan portfolios, which require coverage of a similar “core” group of exposures. The principal difference relates to the manner in which loans outside the core group are selected for review. Under the traditional approach, the largest remaining loans are selected until a desired coverage ratio is achieved. Using sampling, the remaining noncore loans are grouped into several strata, or buckets, based on the size of the borrowing relationship. Loans are randomly selected from each of these buckets proportionate to the dollar value of each bucket relative to the total noncore portfolio. The total number of sampled loans required is determined by the number and size distribution of loans in the bank’s portfolio.

The sampling approach is an effective means to determine if the examiner can rely on the bank’s classification process or whether the examiner must determine the level of classifications by traditional means. Although sampling may, in some cases, require examiners to review more loans than required by the traditional loan-coverage approach, sampling is more likely to detect problems among smaller loans and will provide a broader perspective of the bank’s classifications across the entire portfolio.

In most cases, examiners should expect to find very few misclassifications within the sampled buckets, since those segments would exclude any credits that the bank’s internal procedures have identified as weak and those that the examiner has otherwise identified for specific review (the ‘‘core’’ loans). When the examiner’s classifications agree with the bank’s internal loan classifications, then internal classification totals can be relied upon in calculating the total and weighted asset-classification ratios. However, if misclassifications are found within the sample, internal classifications may underestimate the true extent of problem loans, and the examiner must make adjustments to estimate the actual extent of problems. To make that estimate, the rate of misclassification is applied to the remaining loans in the sampled bucket to derive an estimate of other problems that the examiners would likely find if all the loans were read. This extrapolated amount of problem loans is then added to the total of specifically identified problems to evaluate the significance of credit weaknesses at the institution. Depending on the severity of misclassifications and the magnitude of problems specifically identified, expansion of the examination scope will probably be necessary to better assess the accuracy of loan grading.

Specific Procedures

Using electronic loan files provided by the bank (for example, those loan files available in the Automated Loan Examination Review Tool (ALERT) format) and the System's loan-sampling software, examiners are able to construct a variety of core and noncore borrower groups. (See table 1.) The "core" group—bucket 1—consists of several categories of loans that examiners have traditionally reviewed and would continue to review using sampling. These core borrowers include, for instance, the largest exposures and certain large problem or insider loans. The sampling program also permits examiners to select any additional borrower (or borrowers) for review based on the examiner's experience and judgment. These individually selected loans would be placed in the "examiner-selected" group—bucket 2. All loans contained in buckets 1 and 2 would be individually reviewed, not sampled, and examiners would not extrapolate their findings to other loans. All remaining internally identified problem borrowers are included in a separate "problem" group—bucket 3—designated as "discuss only"; these borrowers are not incorporated into the commercial-loan-coverage ratio nor are their findings extrapolated to other loans within the same bucket. However, any borrower in the "problem" group—bucket 3—may be individually selected for review by the examiner. Additionally, if the number of "discuss-only" borrowers in the "problem" group—bucket 3—is large, the examiner may select a number of borrowers to be randomly sampled.

The remaining noncore categories represent "pass" or creditworthy loans, grouped by the size of the borrowing relationship. Buckets 4 through 8 are composed of loans to be randomly sampled. The number of loans selected from buckets 4 through 8 is proportional to its total dollar value relative to the total noncore portfolio. Thus, if loans in a particular category represent 30 percent of the bank's total noncore exposures, then approximately 30 percent of the number of sampled credits will be drawn from that category. A "custom" group—bucket 4—is available for examiners to target specific borrowers meeting a variety of selection criteria. Buckets 5 through 8 represent all remaining loans in the commercial loan portfolio, segregated by size relative to the bank's tier 1 capital and loan-loss reserve. The results of examiners' findings for these sampled buckets would be extrapolated to the entire group of borrowers not reviewed.

Determination of Reliance on a Bank's Internal Classifications

Once the commercial loans have been selected for review, examiners are expected to use existing credit-analysis techniques as described in this manual to evaluate the borrower's creditworthiness, determine the level of adverse classifications, and identify any discrepancies with the bank's internal classifications.

In performing their analysis of the accuracy of classified credits, examiners should start with the assets internally classified by the bank's rating system and add any pass credits that were misclassified by the bank and downgraded to a classified status during the examiner's credit review. These classified assets are the key component for a "base" weighted asset-classification ratio.

Under the sampling program, the "base" weighted asset-classification ratio must be adjusted upward (extrapolated) to the extent misclassifications were uncovered within the randomly sampled loan buckets. The resulting extrapolated weighted asset-classification ratio is necessary to account for the likelihood that misclassifications uncovered from the sampled loans represent only a small portion of the total misclassified loans throughout the rest of the portfolio that was not reviewed. The extrapolated value provides examiners with a more comprehensive picture of the magnitude of the institution's credit problems.

In many cases, there will be no disagreements between the examiner's credit analysis and the bank's internal classifications. Consequently, there will be no difference between the weighted asset-classification ratio and the extrapolated ratio. Generally, no additional sampling would be necessary. However, other types of credit-administration weaknesses may be discovered

Table 1—Groups of Loans Available for Review

Bucket	*Description*
	Nonsampled Buckets
Bucket 1 Core*	1A: largest non-insider non-problem-borrower exposures* 1B: largest non-insider non-problem-borrower exposures underwritten in the previous 12 months* 1C: largest non-insider problem-borrower exposures* 1D: largest insider borrower exposures*
Bucket 2 Examiner-selected	Examiner optional group. Examiners may manually select any borrower to review.
Bucket 3 Problem	Problem loans (Watch list, >59 days past due, internal ratings, and previously classified). Discuss-only borrowers.
	Sampled Buckets
Bucket 4 Custom	Examiners may select to target specific borrowers meeting a variety of criteria.
Bucket 5 >3% T1	Remaining borrower exposures greater than 3 percent of tier 1 capital plus the ALLL.
Bucket 6 2%–3% T1	Remaining borrower exposures between 2 percent and 3 percent of tier 1 capital plus the ALLL.
Bucket 7 1%–2% T1	Remaining borrower exposures between 1 percent and 2 percent of tier 1 capital plus the ALLL.
Bucket 8 0.1%–1% T1	Remaining borrower exposures between 0.1 percent and 1 percent of tier 1 capital plus the ALLL.
Bucket 9 <0.1% T1	Remaining borrower exposures less than 0.1 percent of tier 1 capital plus the ALLL. These loans are not included in the sample.
Bucket 10 Noncommercial	All noncommercial borrowers. Examiners may scope into Bucket 2.

*Up to (i.e., a maximum of) 25 borrower exposures can be included in Bucket 1 (Core). Bucket 1 is comprised of a configuration of the borrower exposures in buckets 1A, 1B, 1C, and 1D, which must include appropriate representation of the largest, largest new, largest problem, and largest insider borrower exposures, respectfully. The number of borrower exposures in each of these sub-buckets should be based on the examiner's judgment and appropriately risk-focused.

that warrant additional review and, as a result, an additional sample of loans may be selected. In this case, the number of loans selected is left to the examiner's judgment.

In other cases, either minor or significant disagreements will require examiners to more fully investigate the reliance that can be placed on the internal classifications. When there are only a minor number of disagreements within the sampled loans, examiners should be aware that those seemingly minor disagreements may translate into fairly large differences between the base and extrapolated problem-loan figures. When those differences are significant enough that they would alter an examiner's overall conclusion regarding the accuracy of the bank's loan-grading system, follow-up work is required. In particular, significant differences between the "base" and extrapolated weighted classification ratios should raise concerns as to whether the institution is systematically misreporting credit problems.

For example, a disagreement may arise between an examiner's analysis and the bank's internal classification of a single credit that was drawn from the sample buckets. Assuming a "base" weighted asset-classification ratio of 4 percent, the disagreed-upon sample loan, when extrapolated, could increase the weighted asset-classification ratio to 7 percent. When the difference between the "base" and extrapolated ratios is not material, it would not be necessary to select additional loans if the ratio difference would not alter the examiner's conclusions regarding the condition of the loan portfolio.

In another situation, there may be disagreement between the examiner's analysis and the bank's internal rating on two small-dollar loans sampled from bucket 8 (borrower exposures between 0.1 percent and 1 percent of tier 1 capital plus the allowance for loan and lease losses (ALLL)). In this example, the bank's "base" weighted asset-classification ratio is calculated to be 3 percent. Individually, these loans do not play a significant role in the level of the "base" ratio. However, when these same disagreed-upon classifications are extrapolated, the result is a significant difference between the "base" ratio and the extrapolated classification ratio of 18.5 percent. This can occur when there are only four loans that are sampled from bucket 8, and the two loans in disagreement account for 40 percent of the dollar volume of the sampled loans. Through extrapolation, 40 percent of the remaining bucket 8 loans would be considered classified, thereby increasing the extrapolated ratio to a level that may cause an examiner to question the reliability of the bank's classification system.

In the preceding example, to rule out the possibility that misclassifications were identified as a matter of chance, examiners should expand their loan coverage by pulling an additional sample from the bucket in which the misclassifications were identified. If the examiner selected four additional borrowers from bucket 8 to review and no new misclassifications were found, the extrapolated ratio would decline to 11 percent. As the base and extrapolated ratios move much closer together, the examiner may have greater confidence in the bank's internal loan-rating system and place greater reliance on bank-identified problems in evaluating the bank's asset quality. However, when reviewing the additional four back-up loans, if the examiner found one new misclassification, then the extrapolated ratio would be 15 percent. In these cases, it is highly unlikely that the misclassifications were caused by chance, and it is probable that a systematic problem exists in the ability of bank management to correctly risk-rate their commercial loans. Consequently, examiners should closely review the misclassifications and determine if any pattern exists, such as loans generated from a specific originating office or loan officer, or by type of credit extension. In these cases, internal classifications should be deemed unreliable and further credit review should be performed to evaluate the full extent of problem assets. That expanded review should be consistent with the minimum loan coverage of 55 percent to 65 percent or more, as required for banks posing supervisory concerns. (See SR-94-13, which is partially superseded by SR-14-4 and section 2086.1.)

Factoring Sampling Results into Examination Findings

An evaluation of a bank's asset-quality rating within CAMELS should take into account both financial and managerial factors as detailed in SR-96-38. When using the sampling approach, the extrapolated weighted classification ratio is to be used as a tool for assessing the extent to which examiners may rely on the bank's internal classifications. To the extent loan sampling indicates that the bank's internal classifications are not reliable, the severity of that fundamental risk-management weakness should be factored into the asset-quality rating as well as the management and the risk-management rating. Results of the statistical loan sampling should be documented in the examination report. As for needed documentation, the traditional weighted classified asset ratio should appear in the open section of the examination report, and the extrapolated ratio should appear in the confidential section of the report. In cases where an expanded review was called for, the initial "base" classified asset ratio should also be noted, along with the final classified asset ratio resulting from the expanded review. (See the examination procedures, section 2082.3, for a detailed description of the required information.)

Discussions with Management Regarding the Sampling Procedures

The sampling procedure produces an extrapolated estimate of weighted classified assets. The principal use of extrapolation is to provide an *estimate* of what the weighted asset-classification ratio would be for the entire loan portfolio. The extrapolated ratio will differ significantly from the traditional weighted asset-classification ratio when errors in the bank's internal classification system are detected through random sampling. Examiners may want to discuss (1) how the errors led to a widening of the loan-review scope and (2) the degree of errors found in the loans pulled beyond the initial sample. Any uncertainties regarding the integrity of the institution's classification system or the extent of its asset-quality problems uncovered from the use of sampling (that resulted from rating errors) should be discussed with management and included in the examination report, along with any necessary follow-up work required to gain more certainty. Those discussions may center on the number of errors uncovered in sampled and core loans.

1. To evaluate and improve, using statistical sampling, the comprehensiveness and effectiveness of the examination's credit review of a bank's loan portfolio.
2. To better evaluate, using statistical sampling, a bank's internal credit-review process and also the effectiveness of its credit risk-management practices.
3. To assess the accuracy of the bank's internal credit classifications.

1. Using the Federal Reserve System's loan-sampling software and the electronic files provided by the bank under examination (for example, those in the Automated Loan Examination Review Tool (ALERT) format), develop the bank's core and sampled borrower groups. (See table 1 in section 2082.1.) Follow the "Specific Procedures" of section 2082.1 for selecting loans for review, including those that are to be randomly sampled.
2. Use the bank examination credit-analysis techniques in this manual to—
   a. evaluate the borrower's creditworthiness,
   b. determine the level of adverse classifications, and
   c. identify any discrepancies within the bank's internal classifications.
3. Continue to follow the "Specific Procedures."
   a. Be especially alert when reviewing loan misclassifications to detect patterns of misclassifications (for example, whether the misclassified loans were generated by a specific originating office or loan officer).
   b. When misclassifications are identified, be prepared to expand the scope of the loan review.
   c. Ascertain whether the bank is systematically misreporting credit problems.
4. When it is determined that the bank's internal classifications are unreliable, factor the severity of this risk-management weakness into the asset-quality, management, and risk-management ratings.
5. Include the following information in the examination report (for instance, the information illustrated below):
   a. Report the traditional weighted asset-classification ratio in the open section of the examination report.
   b. Report the extrapolated weighted asset-classification ratio, the traditional asset-classification ratio, and the number of errors found in the sampled buckets in the confidential section of the report.
   c. If an expanded sample was undertaken because of misclassification errors, report in the confidential section the number of additional loans selected, any errors from the expanded sample, and the adjusted weighted and extrapolated asset-classification ratios.

The illustration below is a sample table format that may be used to highlight the sampling findings within the indicated sections of the examination report.

Loan-Sampling Results—Items to Be Reported in the Examination Report

Open section	
Traditional weighted asset-classification ratio	%
Confidential section	
Extrapolated weighted asset-classification ratio	%
Number of borrowers sampled	
Number of errors in sampled buckets	
Expanded-sample information	
Number of sampled borrowers in expanded review	
Number of errors in expanded review	
Adjusted weighted asset-classification ratio	%
Adjusted extrapolated weighted asset-classification ratio	%

Loan Coverage Examination Requirements for Community State Member Banks with $10 Billion or Less in Total Consolidated Assets

Effective date October 2015

Section 2002.1

This guidance sets forth the loan- sampling expectations for Federal Reserve led examinations of community state member banks and clarifies when statistical sampling is expected to be used.[1] In addition, the guidance establishes minimum coverage[2] expectations for judgmental samples for full-scope and asset-quality target examinations. Examiners are expected to select for review a sample of loans[3] 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. In selecting a sample of loans for review, examiners should be guided by the following requirements.

COMMERCIAL AND INDUSTRIAL AND COMMERCIAL REAL ESTATE LOANS

For community state member banks with CAMELS composite and Asset Quality ratings of "1" or "2" that have not materially changed the composition of their loan portfolios or their credit administration practices since the prior examination, and whose most recent overall SR-SABR rating is not "1D," "1F," "2D," or "2F,"[4] examiners are expected to use the statistical loan-sampling procedures outlined in section 2082.1.[5] Examiners are not expected to supplement statistical samples with additional loans to reach the specified minimum coverage ratios discussed below for judgmental samples.[6]

For all other community state member banks, examiners should draw a judgmental sample that includes a selection of large, insider, problem,[7] watch, renewed, and new credits.[8] The sample should mainly be drawn from the bank's primary lending business lines, new business lines, and out-of-area loans or highly specialized lending or leasing portfolios. Coverage targets should factor in the bank's current asset quality rating and credit risk management assessment. More specifically, for community state member banks with "weak" credit risk management practices, with asset quality component ratings of "3 or worse," or where SR-SABR ratings of "D" or "F" raise questions about loan quality, coverage should be 40 percent or more. Community state member banks with strong or acceptable credit-risk management practices and asset quality component ratings of "1" or "2" should have 20 to 30 percent coverage. This is illustrated further in the table below.

It may be necessary to expand the sample when using either statistical or judgmental sampling in situations where there are several differences in credit ratings between those assigned by examiners and bank management. To expand the sample when using the statistical sampling methodology, examiners should follow the guidance discussed in section 2082.1. When using judgmental sampling, examiners should generally consider a community state member bank's internal risk-rating system to be unreliable when examiner downgrades[9] are 10 percent or more of

1. With the issuance of this guidance, SR-94-13, "Loan Review Requirements for On-site Examinations," is superseded only for Federal Reserve led examinations of community state member banks.

2. A loan review coverage ratio, or "coverage," should be calculated by dividing the dollar volume of commercial and industrial and commercial real estate loans reviewed during the examination by a bank's total dollar volume of such loans in the bank's loan portfolio. Credit exposures arising from trading and derivatives activities should not be included in the coverage ratio.

3. For the purposes of this section 2086.1, the term "loans" includes all sources of credit exposure arising from loans and leases. Such exposure includes guarantees, letters of credit, and other loan commitments. Both funded and unfunded commitments should be considered when assessing loan exposure.

4. For additional information on SR-SABR, see SR-06-2, "Enhancements to the System's Off-Site Bank Surveillance Program," this manual's section 1020.1.

5. For section 2086.1, "Commercial and Industrial and Commercial Real Estate Loans" include all non-consumer related loan categories.

6. Footnote reserved.

7. Problem loans are comprised of past due loans, nonaccrual loans, impaired loans, renegotiated or restructured loans, loans internally criticized or classified by the bank, and loans that were classified at the previous examination.

8. Together, these credits constitute the "core" loan categories.

9. A credit risk grading difference is considered a downgrade when: 1) a risk rating is changed by the examiner from an internal Pass rating to Special Mention or classified category, 2) a risk rating is changed by the examiner from Special Mention to a classified category, or 3) a risk rating is lowered by the examiner within the classified categories, including a split classification.

<table>
<tr><th rowspan="2">Asset Quality Component Rating</th><th colspan="3">Credit Risk Management</th></tr>
<tr><th>Strong</th><th>Acceptable</th><th>Weak</th></tr>
<tr><td>1</td><td colspan="2" rowspan="2">20 to 30 percent coverage*</td><td rowspan="2"></td></tr>
<tr><td>2</td></tr>
<tr><td>3</td><td colspan="3" rowspan="3">40 percent or more coverage</td></tr>
<tr><td>4</td></tr>
<tr><td>5</td></tr>
</table>

*Where SR-SABR ratings of "D" or "F" raise questions about loan quality, coverage should be 40 percent or more.

the total number of credit facilities reviewed, and 5 percent or more of the total dollar amount of loans reviewed. When a bank's risk-rating system is determined to be unreliable, examiners may need to expand sampling to better evaluate the effect of rating differences on the bank's allowance for loan and lease losses (ALLL) and capital. In such situations, examiners should direct the bank to promptly take corrective action to validate its internal ratings and to evaluate whether the ALLL or capital should be increased. The Reserve Bank should follow up with the bank to assess progress on corrective action and verify satisfactory completion. The timeframe for follow-up will depend on the nature and severity of problems identified and typically should be no more than six months after the Reserve Bank notifies the bank of the deficiencies.

RETAIL CONSUMER LENDING

Retail consumer lending involves a large number of relatively homogenous, small-balance loans such as installment loans, credit card receivables, home equity lines of credit (HELOCs), and residential mortgages. The supervisory review and classification of retail consumer loans should be carried out in accordance with the procedures set forth in the *Commercial Bank Examination Manual* and SR-00-8, "Revised Uniform Retail Credit Classification and Account Management Policy" (see section 2130.1, "Consumer Credit") and will generally be limited to past due and nonperforming assets.[10]

When a bank has a concentration (defined as more than 25 percent of the bank's tier 1 capital plus ALLL) in retail consumer loans, examiners should include in their examination scope a review of the retail lending program, its underwriting standards and policies, and related risks and controls. Examiners should also consider sampling a portion of credits in those segments (for instance, residential mortgages or HELOCs) of the bank's retail loan portfolio with a high concentration in order to assess risks and the adequacy of underwriting, internal controls, and credit risk management practices. A judgmental sample size should be used that is commensurate with concentration and credit risks and sufficient for the examiner to assess the quality and risks of the portfolio.

Loan Coverage of Commercial and Industrial and Commercial Real Estate Loans in a Target Examination

The Federal Reserve may deem it necessary to conduct a target examination prior to the next statutorily required full-scope examination.[11] Such target examinations should be risk-focused in accordance with existing guidance, including SR-97-25, "Risk-Focused Framework for the Supervision of Community Banks" (see section 1000.1, "Examination Strategy and Risk-Focused Examinations"). Any loan coverage goals should be determined using the judgment and discretion of the supervision staff involved in establishing the scope of the examination. For banks with a "3" composite rating, loan coverage of 30 percent or more should be achieved at a target examination that includes a review of asset quality. For banks with a "4" or "5" composite rating, loan coverage of 40 percent or more should be achieved at the target examination.

Loan coverage may consist of updates to credits reviewed and classified or downgraded at the previous examination and any credit originated or extended since the previous examination. The examination results should be used to update the asset quality and credit-risk manage-

10. See section 2130.3, "Consumer Credit (Examination Procedures)."

11. SR-85-28, "Examination Frequency and Communicating with Directors," indicates targeted examinations will be conducted when deemed necessary by the Reserve Bank between statutorily required examinations (refer to section 1000.1). The Federal Reserve's examination frequency requirements for state member banks are in Regulation H (12 CFR 208.64).

ment assessment and inform the level of coverage needed at the next full-scope examination. Deteriorating asset quality or uncorrected credit-risk management deficiencies noted at the target examination would generally necessitate expanded coverage for the next full-scope examination.

Documentation of Loan Review Coverage

The scope of loan coverage and the loan-sampling procedures used in the examination process should be documented within examination workpapers and the examination report.[12] In particular, examiners should ensure that the composition and volume of the reviewed loans are documented within the examination report. This documentation should include the core loan categories that were included in the sample, the loan portfolio segments that were the focus of the review, and cutoff values that were used in deciding which loans are included in the sample. Documentation supporting the establishment of the sample should be included in the workpapers.

12. See section 1030.1, "Workpapers."

This manual section sets forth loan sampling expectations for the Federal Reserve's examination of state member bank (SMB) and credit-extending nonbank subsidiaries of bank holding companies with greater than or equal to $10 billion and less than $100 billion in total consolidated assets. Refer to SR-14-4, "Examiner Loan Sampling Requirements for State Member Bank and Credit Extending Nonbank Subsidiaries of Bank Holding Companies in the Regional Banking Organization Supervisory Portfolio," for more information about revisions to the guidance and implementation information. Examiners 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. The guidance clarifies expectations for the assessment of material retail-credit portfolios for these institutions.[1]

A thorough review of a bank's loan and lease portfolio remains a fundamental element of the Federal Reserve's examination program for SMBs. Such credit reviews are a primary means for examiners to (1) evaluate the effectiveness of a bank's internal loan review program and internal grading systems for determining the reliability of internal reporting of classified and Special Mention credits, (2) assess compliance with applicable regulations, and (3) determine the efficacy of credit-risk management and credit-administration processes. Further, examiners use the findings from their credit review to identify the overall thematic credit-risk management issues, to assess asset quality, to assist in the assessment of the adequacy of the allowance for credit losses (ACL), and to inform their analysis of capital adequacy.

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. When calculating a concentration of credit in a loan portfolio or portfolio segment, total risk-based capital refers to tier 1 capital plus the plus the portion of the allowance for credit losses (ACL) attributed to loans and leases. See SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach," for additional information.

LOAN SAMPLING METHODOLOGY

Reserve Banks will establish the annual loan sampling objective during the supervisory planning process. The annual sampling objective should provide coverage of material exposures, including those in the retail segments.[2] Reserve Banks should plan on conducting at least two loan quality reviews during the annual supervisory cycle of SMBs with greater than or equal to $10 billion and less than $100 billion in total consolidated assets.

Each review should focus on one or more material commercial loan segment exposures by Call Report loan type and, in total over the annual cycle, should cover the four highest concentrations for commercial credits in terms of total risk-based capital for any Call Report loan type from Schedule RC-C. Loan segments that generate substantial revenues are generally likely to entail higher risk. To the extent that examiners can determine that a loan category contributes 25 percent or more to annual revenues, examiners should sample these segments.[3] Examiners should also sample other loan segments that they or the bank's internal loan review have identified as exhibiting high-risk characteristics. Such risk characteristics include liberal underwriting, high levels of policy exceptions, high delinquency trends, rapid growth, new lending products, concentrations and concentrations to industry, significant levels of classified credits, or significant levels of Special Mention credits. In addition to these risk-focused samples, a sample of loans to insiders must be reviewed.[4] Annual loan-sampling coverage by examiners should take into consideration the severity of the asset quality component rating, the effectiveness of the internal loan review program, the results of

2. Commercial loan segments include commercial and industrial (C&I) loans, 1–4 family construction, other construction loans, multifamily loans, farm loans, non-farm non-residential owner occupied, and non-farm non-residential other loans. Retail loan segments include first-lien mortgages, closed-end junior liens, home equity lines of credit (HELOCs), credit cards, automobile loans, and other consumer loans.

3. The 25 percent threshold should be based on internal management information systems and may not be applicable or available in all instances. For the purposes of this guidance, annual revenue equals net interest income plus noninterest income.

4. Federal Reserve examiners must test and evaluate Regulation O (12 CFR pt. 215) compliance annually.

internal loan portfolio stress testing, and current asset quality financial trends.

During the examination scoping phase, Reserve Bank staff should analyze the results of recent loan review reports or audits prepared for an institution's internal use and the Reserve Bank's most current assessment of credit-risk management to help establish the size and composition of loans to be selected for review. An institution's internal loan review program should achieve substantial coverage beyond the examiners' annual judgmental sample of material loan portfolios. Examiners should review the findings and recommendations of the institution's internal loan review program to help identify areas of risk. In selecting loans from each segment of the loan portfolio to review, examiners should include a selection of the largest loans, problem loans (past due 90 days or more, nonaccrual, restructured, Special Mention, watch list, or internally classified loans), and newly originated loans. Examiners should ensure the sample selection includes robust coverage of classified, Special Mention, and watch credits. At a minimum, loans selected for review from commercial loan segments should represent 10 percent of the committed dollar amount of credit exposure within the loan segment.

Sample sizes should be increased beyond the 10 percent minimum, based on examiner judgment, for segments when the examination-scoping process or the internal loan review program has identified

1) deficiencies with credit-risk management and administration practices,
2) loan growth that has been unusually high,
3) credit quality or collateral values that have been adversely affected since the prior review by volatile local or national economic conditions, or
4) unreliable internal credit-risk grading.

Conversely, sample sizes should be based on the 10 percent minimum if

1) previous examinations concluded that internal loan review and credit-risk identification is effective,
2) internal loan review has reviewed a loan segment within the last 12 months and noted no material weaknesses, and
3) the examination-scoping process reveals no significant credit-risk management issues.

In general, the lower range of a 10 percent sampling of each segment or the entire commercial portfolio would be acceptable when all aspects of credit risk indicate low and stable risk.

Examiners should determine classification amounts for retail credits using the Uniform Retail Classification Guidance (SR-00-8, "Revised Uniform Retail Credit Classification and Account Management Policy"). Annually, examiners should focus on one or more material retail loan segment exposures by Call Report loan type. Examiners should determine the appropriate sample of retail loans from material segments based on risk to be tested for compliance with internal credit-administration policies and underwriting standards. While there is no minimum coverage expectation for retail portfolios or segments, the goal of sampling is to assist examiners in making an informed assessment of all aspects of retail credit-risk management. If applicable, examiners should evaluate and test secondary market origination and servicing practices and quality assurance programs. Examiners should also sample other retail loan segments, as needed, from segments the examiners or internal loan review identify as exhibiting high-risk characteristics such as liberal underwriting, high delinquency trends, rapid growth, new lending products, or significant levels of classified credits.

DOCUMENTATION OF LOAN SAMPLING ANALYSIS AND METHODOLOGY

Examiners should discuss their analysis and objectives for achieving loan sampling coverage with Board staff during the annual supervisory planning process. Upon reaching a consensus with Board staff, the analysis and methodology should be retained in workpapers and documented in the supervisory plan. Further, examiners should document their loan sample selection methods in scoping memoranda and in the confidential section of the report of examination. The required workpaper documentation of the commercial loan coverage calculation should be based on total loan commitments and should generally exclude loans reviewed outside of the Reserve Bank's supervisory plan when a detailed analysis of the loans by an examiner and an assessment of credit-risk management were not performed. Review of syndicated loans and participations, such as those from the Shared National Credits (SNCs) annual review, should only be included in the coverage ratio if Reserve Bank staff reviewed the credit-risk management aspects of the credit (for example, adherence to underwriting policies) and these findings are included in the examiner's assessment of overall credit-risk management practices. Examiners should continue to follow the SNC grading guidance.[5]

FOLLOW-UP EXPECTATIONS FOR EXAMINATIONS WITH ADVERSE FINDINGS

Examiners should generally consider a bank's internal risk-rating system to be less reliable when examiner downgrades or internal loan review downgrades equal 10 percent of the total number of loans reviewed, or 5 percent of the total dollar amount of loans and commitments reviewed.[6] When a bank's risk rating system is determined to be unreliable, examiners may need to expand sampling to better evaluate the effect of rating differences on the bank's ACL and capital. In such situations, examiners should direct the bank to take corrective action to validate its internal ratings and to evaluate whether the ACL or capital should be increased. The Reserve Bank will follow-up with the bank to assess progress on corrective action and verify satisfactory completion. The timeframe for follow-up should correspond with the timeframe during which actions are to be completed.[7] All follow-up actions on adverse findings should be discussed with Board staff.

5. Refer to SR-77-377, "Shared National Credit Program."

6. A credit-risk grading difference is considered a downgrade when a) a risk rating is changed by the examiner from an internal Pass rating to Special Mention or classified category, b) a risk rating is changed by the examiner from Special Mention to a classified category, or c) a risk rating is changed by the examiner within the classified categories.

7. Refer to this manual's section, "Examination Strategy and Risk-Focused Examinations."

State member banks with less than $100 billion in total assets, in the community banking organization and regional banking organization supervision portfolios, 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 state member bank is amenable to such an arrangement, and the bank is able to securely send legible and sufficiently comprehensive loan information to the Reserve Bank.[1]

In the past, the Federal Reserve's off-site examination work focused on financial performance analyses and the review of bank policies, procedures, and certain bank internal reports.[2] With technological advancements, such as secure data transmission and electronic file imaging, examiners have the ability to collect and review loan file information off site without compromising the effectiveness of the examination process. Therefore, Federal Reserve examiners may use the off-site loan review program when a state member bank has communicated its willingness to participate in the program and can appropriately image and send its loan documents to the Reserve Bank in a secure manner.

PROCESS FOR DETERMINING WHETHER A STATE MEMBER BANK MAY PARTICIPATE IN THE OFF-SITE LOAN REVIEW PROGRAM

A Reserve Bank will contact a state member bank prior to the start of an examination to confirm whether the institution has an interest in participating in the off-site loan review program.[3] A bank interested in participating in the program needs to be able to demonstrate its ability to appropriately image and send loan documents to the Reserve Bank. In assessing a bank's ability to participate in the off-site loan review program, a Reserve Bank will consider the bank's answers to the following questions:

- Will the institution submit the loan file data using a secure transmission method such as cloud-based collaboration products, secure email services, encrypted removable media, virtual private networks, or remote desktop control services?
- Is the institution able to provide loan data and imaged loan documents that are legible, easily viewable, and properly organized to allow for timely review by examiners?
- Are the loan files comprehensive to allow an examiner to come to a conclusion as to the appropriate rating of a credit without having to request additional information from the institution?

For state member banks that have demonstrated these technological capabilities, the Reserve Bank should make all efforts to accommodate the request for an off-site loan review. However, a Reserve Bank may decline a request if the Reserve Bank has justifiable reasons to believe that an off-site review would impede the examiners from efficiently and effectively assessing the institution's asset quality and credit risk management process.

SECURITY OF LOAN FILE DATA SUBMITTED TO THE RESERVE BANKS

Reserve Bank examiners must handle a state member bank's loan file data in accordance with existing Federal Reserve information security requirements. A Reserve Bank should explain its procedures and practices for safeguarding loan file data to a state member bank as part of the discussion as to whether or not to participate in the off-site loan review program. This includes an explanation about the Reserve Bank's procedures for coordinating off-site loan reviews with state banking agencies. Further, Reserve Banks and the state member bank should discuss the technical procedures and security practices for conducting off-site loan reviews when contin-

1. Refer to SR-16-8, "Off-Site Review of Loan Files." The guidance in SR-16-8 also is relevant to the supervision of U.S. branches and agencies of foreign banking organizations with combined U.S. assets of $50 billion or less.

2. Refer to SR-95-13, "Recommendations to Increase the Portion of Examinations and Inspections Conducted in Reserve Bank Offices."

3. In order for a Reserve Bank to be able to complete an off-site loan review, a state member bank will need to submit all requested information in a timely manner, including confirming its interest in being considered for the off-site review program and providing all the necessary information for a Reserve Bank to confirm the institution's technological preparedness.

gency operating circumstances necessitate a full-time telework environment for Reserve Bank examiners.

ADJUSTMENTS TO THE EXAMINATION PROCESS

Reserve Banks need to adjust their examination process in order to execute an off-site loan review. For example, examiners allocate time prior to the start of the examination to confirm that a state member bank has successfully transmitted its loan file data to the Reserve Bank. Further, examiners are expected to maintain ongoing communication with the institution's management during the examination process. Prior to the start of the examination, examiners establish a schedule with the institution's management for status calls during the off-site portion of the examination. Typically, examiners will conduct regular calls with management to discuss loan file review and the status of other examination work.

SCOPE OF THE OFF-SITE EXAMINATION WORK

Reserve Banks will try to conduct as much of the examination work off site as feasible without compromising the effectiveness of the examination process. Specific to loan review, examiners typically conduct the following portions of examination work off site regardless of whether the state member bank is participating in the off-site loan review program. This examination work includes

- determination of the scope of the loan review;
- risk assessment to determine the areas to be emphasized (for example, management of credit concentrations and the loan approval process);
- review of the bank's loan policies;
- review of financial performance reports and management reports;
- preliminary review of the loan loss reserve methodology;
- determination of the loans to be reviewed, and the selection of individual credits;
- grouping of loans to related obligors; and
- preparation of loan line sheets.

In addition, for a state member bank participating in the off-site loan review program, examiners will perform an off-site the review of credit files for quality, documentation, and compliance with bank policy and laws and regulations. Further, at the discretion of the examiners, Reserve Banks may hold either off-site or on-site discussions with the institution's management regarding preliminary loan review findings such as the appropriateness of individual credit ratings assigned by the state member bank and the completeness of credit file documentation.

SCOPE OF ON-SITE EXAMINATION WORK

On-site examination work remains an indispensable component of bank supervision that plays a critical role in the ability of the Federal Reserve to fulfill its supervisory responsibilities. Reserve Banks are expected to continue to perform on site those activities that require physical observation such as transaction testing and direct monitoring of an institution's operations and internal controls. While on site, examiners will also review documents such as meeting minute books of the board of directors that would be inappropriate or impractical for the state member bank to send to the Reserve Bank. Further, unless contingency operating circumstances necessitate teleworking arrangements, Federal Reserve examiners will conduct exit meetings in person with the institution's management to communicate final supervisory findings and conclusions, including the final supervisory findings from any off-site loan review examination work. (Refer to SR-16-8.)

INTRODUCTION TO THE SHARED NATIONAL CREDIT PROGRAM

In 1977, the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) (collectively "the agencies") established the Shared National Credit (SNC) program to evaluate large and complex syndicated credits. The program provides for uniform treatment and increased efficiency in shared-credit risk analysis and classification of the largest and most complex credits shared by multiple financial institutions. The SNC program facilitates the collection and analysis of data on the largest and most complex credits and gives examiners from the agencies a medium to assess the risk-management practices associated with such credits. The SNC program is governed by an interagency agreement among the agencies.

DEFINITION OF A SHARED NATIONAL CREDIT

An SNC is any loan or formal loan commitment, and any asset such as real estate, stocks, notes, bonds, and debentures taken as debts previously contracted, extended to borrowers by a federally supervised institution (explained in the subtopic below entitled, "Shared National Credit Reporting"), its subsidiaries, and affiliates, that aggregates to $100 million or more and is shared by three or more unaffiliated federally supervised institutions, or a portion of which is sold to two or more unaffiliated federally supervised institutions.[1] The agencies may designate any other large credit as meeting the general intent or purpose of the SNC program. Other examples of SNCs include

- all international credits to borrowers in the private sector regardless of currency denomination that are administered by a U.S. domestic office of the institution.
- two or more credits to the same borrower for the same origination date where the aggregate commitment amount of the credits is greater than or equal to $100 million and is shared by three or more unaffiliated, supervised participant lenders. All unaffiliated supervised participant lenders should be lenders in each credit.
- any credit facility or tranche of a syndicated loan agreement that equals $100 million or more and includes three or more federally supervised institutions as well as all the other credit facilities or tranches subject to that credit agreement, regardless of the dollar amount or the number of federally supervised institutions participating in them.[2]

SHARED NATIONAL CREDIT REPORTING

The agent or administrative agent of the SNC is responsible for submitting credit data to the agencies. The agent is the federally supervised institution that originates an SNC or administers the credit for the syndication or participating lenders. For the purposes of the SNC program, a federally supervised institution is any financial institution, including subsidiaries, subject to supervision by one of the agencies. More specifically, federally supervised institutions that are part of the SNC program include

- FDIC-insured banks (for example, state member banks, nonmember banks, and national banks) and thrifts, their branches and subsidiaries;
- bank holding companies, and their non-bank subsidiaries subject to examination by the Federal Reserve System;
- savings and loan holding companies;
- federally and state-licensed branches and agencies of foreign banks (including non-U.S. branches managed by a U.S. branch); and
- U.S. subsidiaries of foreign banking organizations.

U.S. representative or loan production offices of foreign banks are not required to report to the agencies for SNC purposes.

1. Effective January 1, 2018, the aggregate loan commitment threshold for inclusion in the SNC program increased from $20 million to $100 million to adjust for inflation and changes in average loan size. The 2018 increase in the dollar threshold to $100 million for inclusion as an SNC was the first since the program's inception in 1977.

2. Each tranche/facility is reported as a separate credit when a credit agreement has tranches/facilities with different terms or participant groups.

The agencies divide SNC reporters into two categories: "basic" and "expanded" filers. Basic filers report SNCs and submit an agent file to the agencies. Basic filers do not submit a participant file.

Expanded filers are typically larger institutions and are subject to more comprehensive reporting expectations than basic reporters. In comparison to basic filers, expanded filers are required to submit all syndicated credits (SNC and non-SNC alike) to the agencies. Syndicated credits include all credits that are arranged and extended by two or more financial entities regardless of the number of participants that are considered regulated entities. While SNCs must have a commitment amount of at least $100 million, there is no minimum commitment amount with syndicated credits. Expanded filers are also required to report participant files, which include structure and ratings information for all credits purchased. Expanded filers also report Basel-related data to the agencies.

SHARED NATIONAL CREDIT EXAMINATIONS

Historically, the agencies conducted annual SNC reviews. Starting in 2016, the agencies initiated a semiannual SNC examination schedule and now conduct SNC reviews in the first and third calendar quarters, with some banks receiving two reviews and others receiving a single review each year. The first quarter SNC review uses data collected from federally supervised institutions in the third quarter of the prior year, and the third quarter SNC review uses first quarter data of the same year. The reported data is analyzed and a sample of credits is selected for review by the agencies and participating state banking supervisors during the examination phase of the program.

The SNC program is governed by agreements among agencies, which include information sharing and program administration procedures for completing reviews of SNCs.[3] In general, teams of three examiners analyze each SNC and assign a disposition to the credit. The credit quality rating assigned by the examination team is reported to each supervised institution that participated in the credit as of the examination date. The assigned ratings are used by the agencies during other examinations of supervised institutions to avoid duplicate reviews and ensure consistent treatment of these credits. After the SNC examination phase is completed, the appropriate agency or agencies compile and distribute the results to the federally supervised institutions that are agents or participants in an SNC.

The agencies issue a single statement annually that includes combined findings from the previous 12 months. This practice presents a complete view of the entire SNC portfolio, which can be compared with prior years' reports. These reports are available on the Board's website.

3. For example, see SR-94-62, "Shared National Credit Program—Interagency Agreement."

The criteria used to assign quality ratings to extensions of credit that exhibit potential problems or well-defined weaknesses are primarily based upon the degree of risk and the likelihood of orderly repayment, and their effect on a bank's safety and soundness. Extensions of credit that exhibit potential weaknesses are categorized as ''special mention,'' while those that exhibit well-defined weaknesses and a distinct possibility of loss are assigned to the more general category of ''classified.'' The term ''classified'' is subdivided into more specific subcategories ranging from least to most severe: ''substandard,'' ''doubtful,'' and ''loss.'' The amount of classified extensions of credit as a percent of capital represents the standard measure of expressing the overall quality of a bank's loan portfolio.

These classification guidelines are only applied to individual credits, even if entire portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each extension of credit should be based upon the fundamental characteristics affecting the collectibility of that particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sector(s).

ASSESSMENT OF CREDIT QUALITY

The evaluation of each credit should be based upon the fundamentals of the particular credit, including, at a minimum—

- the overall financial condition and resources of the borrower, including the current and stabilized cash flow (capacity);
- the credit history of the borrower;
- the borrower's or principal's character;
- the purpose of the credit relative to the source of repayment; and
- the types of secondary sources of repayment available, such as guarantor support and the collateral's value and cash flow, when they are not a primary source of repayment. (Undue reliance on secondary sources of repayment should be questioned, and the bank's policy about permitting such a practice should be reviewed.)

The longer the tenure of the borrower's extension of credit or contractual right to obtain funds, the greater the risk of some adverse development in the borrower's ability to repay the funds. This is because confidence in the borrower's repayment ability is based upon the borrower's past financial performance as well as projections of future performance. Failure of the borrower to meet its financial projections is a credit weakness, but does not necessarily mean the extension of credit should be considered as special mention or be classified. On the other hand, the inability to generate sufficient cash flow to service the debt is a well-defined weakness that jeopardizes the repayment of the debt and, in most cases, merits classification. When determining which credit-quality rating category is appropriate, the examiner should consider the extent of the shortfall in the operating figures, the support provided by any pledged collateral, and/or the support provided by cosigners, endorsers, or guarantors.

Delinquent Extensions of Credit

One of the key indicators of a problem credit is a borrower's inability to meet the contractual repayment terms of an extension of credit. When this occurs, the extension of credit is identified as past due or delinquent. An extension of credit that is *not* delinquent may be identified as special mention or classified. Nondelinquent extensions of credit (also referred to as ''performing'' or ''current'') should be classified when well-defined weaknesses exist that jeopardize repayment. Examples of well-defined weaknesses include the lack of credible support for full repayment from reliable sources, or a significant departure from the intended source of repayment. This latter weakness warrants concern because a delinquent credit may have been brought current through loan or credit modifications, refinancing, or additional advances.

SPECIAL MENTION CATEGORY

A special mention extension of credit is defined as having potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may, *at some future date*, result in the deterioration of the repayment prospects for the credit or the institution's credit position. Special mention credits are not considered as part of the classified extensions of credit category and do not expose an institution to sufficient risk to warrant classification.

Extensions of credit that might be detailed in this category include those in which—

- the lending officer may be unable to properly supervise the credit because of an inadequate loan or credit agreement;
- questions exist regarding the condition of and/or control over collateral;
- economic or market conditions may unfavorably affect the obligor in the future;
- a declining trend in the obligor's operations or an imbalanced position in the balance sheet exists, but not to the point that repayment is jeopardized; and
- other deviations from prudent lending practices are present.

The special mention category should not be used to identify an extension of credit that has as its sole weakness credit-data or documentation exceptions not material to the repayment of the credit. It should also not be used to list extensions of credit that contain risks usually associated with that particular type of lending. Any extension of credit involves certain risks, regardless of the collateral or the borrower's capacity and willingness to repay the debt.

For example, an extension of credit secured by accounts receivable has a certain degree of risk, but the risk must have increased beyond that which existed at origination to categorize the credit as special mention. Other characteristics of accounts receivable warranting identification as special mention include a rapid increase in receivables without bank knowledge of the causative factors, concentrations in receivables lacking proper credit support, or lack of on-site audits of the bank's borrower.

CLASSIFICATION CATEGORIES

Split Classifications

When classifying a particular credit, it may not be appropriate to list the entire balance under one credit-quality category. This situation is commonly referred to as a "split classification" and may be appropriate in certain instances, especially when there is more certainty regarding the collectibility of one portion of an extension of credit than another. Split classifications may also involve special mention as well as "pass" credits, those that are neither special mention nor classified. Extensions of credit that exhibit well-defined credit weaknesses may warrant classification based on the description of the following three classification categories.[1]

Substandard Extensions of Credit

A "substandard" extension of credit is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Extensions of credit so classified must have a well-defined weakness orweaknesses that jeopardize the liquidation[2] of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard credits, does not have to exist in individual extensions of credit classified substandard.

Doubtful Extensions of Credit

An extension of credit classified "doubtful" has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and

1. Guidelines for the uniform classification of consumer-installment extensions of credit and credit card plans, as well as classification guidelines for troubled commercial real estate credits, are discussed in detail in sections 2130.1 and 2090.1, respectively.

2. This terminology is used in the original classification definitions as set forth in the 1938 accord and its amendments. The term "liquidation" refers to the orderly repayment of the debt and not to a forced sale of the loan or its underlying collateral.

improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to the advantage of and strengthen the credit, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors may include a proposed merger or acquisition, liquidation proceedings, capital injection, perfecting liens on additional collateral, or refinancing plans.

Examiners should avoid classifying an entire credit as doubtful when collection of a specific portion appears highly probable. An example of proper use of the doubtful category is the case of a company being liquidated, with the trustee-in-bankruptcy indicating a minimum disbursement of 40 percent and a maximum of 65 percent to unsecured creditors, including the bank. In this situation, estimates are based on liquidation-value appraisals with actual values yet to be realized. By definition, the only portion of the credit that is doubtful is the 25 percent difference between 40 and 65 percent. A proper classification of such a credit would show 40 percent substandard, 25 percent doubtful, and 35 percent loss.

Examiners should generally avoid repeating a doubtful classification at subsequent examinations, as the time between examinations should be sufficient to resolve pending factors. This is not to say that situations do not occur when continuation of the doubtful classification is warranted. However, the examiner should avoid undue continuation if repeatedly, over the course of time, pending events do not occur and repayment is again deferred awaiting new developments.

Loss Extensions of Credit

Extensions of credit classified "loss" are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the credit has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future. Amounts classified loss should be promptly charged off. (See SR-04-9 and its attachment.)

Banks should not be allowed to attempt long-term recoveries while the credit remains on the bank's books. Losses should be taken in the period in which they surface as uncollectible.

In some cases, examiners should determine a reasonable carrying value for a distressed extension of credit and require a write-down through a charge to the allowance for loan and lease losses, or to other operating expenses in the case of an "other asset." Such a determination should be based on tangible facts recorded in the bank's credit file and contained in reports on problem credits submitted to the board of directors or its committee, and not solely on verbal assurances from a bank officer.

SITUATIONS NOT REQUIRING CLASSIFICATION

It is generally not necessary to classify extensions of credit and contingent liabilities that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral. Further, a performing extension of credit should not automatically be identified as special mention, classified, or charged off solely because the value of the underlying collateral has declined to an amount that is less than the balance outstanding. Extensions of credit to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards should not be categorized as special mention unless a potential weakness exists, or classified unless a well-defined weakness exists that jeopardizes repayment. The existence of special mention or classified extensions of credit should not be identified as an imprudent banking practice, as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these extensions of credit.

Partially Charged-Off Extensions of Credit

When an institution has charged off a portion of a credit and the remaining recorded balance of the credit (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, categorization of the remaining recorded balance as special mention or classified may not be appropriate.[3] For example, when the remaining recorded balance of an extension of credit is secured by readily marketable collateral, the portion that is secured by this collateral would generally not be identified as special mention or classified. This would be appropriate, however, if potential or well-defined weaknesses, respectively, continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally receive a credit rating no more severe than substandard.

A more severe credit rating than substandard for the remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, for example, when significant risk exposures are perceived, such as might be the case in bankruptcy or for credits collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Extensions of Credit

Restructured troubled debt should be identified in the institution's internal credit-review system and closely monitored by management. When analyzing a formally restructured extension of credit, the examiner should focus on the ability of the borrower to repay the credit in accordance with its *modified terms*.[4] With formally restructured credits, it is frequently necessary to charge off a portion of the principal, due to the borrower's difficulties in meeting the contractual payments. In these circumstances, the same credit-risk assessment given to nonrestructured credits with partial charge-offs (see the previous subsection) would also generally be appropriate for a formally restructured credit. This includes *not* identifying the remaining recorded balance as special mention or classified if unwarranted. The assignment of special mention status to a formally restructured credit would be appropriate, if, after the restructuring, potential weaknesses remained. It would also be appropriate to classify a formally restructured extension of credit when well-defined weaknesses exist that jeopardize the orderly repayment of the credit, based upon its reasonable modified terms. For a further discussion of troubled debt restructurings, see the glossary section of the Instructions for the Consolidated Reports of Condition and Income and "Loan Portfolio Management," section 2040.1.

ROLE OF GUARANTEES

The primary focus of a review of an extension of credit's quality is the original source of repayment and the borrower's ability and intent to fulfill the obligation without reliance on guarantors.[5] In situations involving troubled credits, however, the assessment of credit quality should also be based upon the support provided by guarantees. As a result, the lending institution must have sufficient information concerning the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation.

Examiner Treatment of Guarantees

A guarantee should provide support for repayment of indebtedness, in whole or in part, and be legally enforceable. It is predicated upon both the guarantor's financial capacity and willingness to provide support for a credit.

To assess the financial capacity of a guarantor and determine whether the guarantor can honor its contingent liabilities in the event required, examiners normally rely on their own analysis of a guarantor's financial strength. This includes an evaluation of the financial statements and the number and amount of guarantees currently committed to.

3. The accrual/nonaccrual status of the credit must continue to be determined in accordance with the glossary section of the Instructions for the Consolidated Reports of Condition and Income (Call Report). Thus, while these partially charged-off credits may qualify for nonaccrual treatment, cash-basis recognition of income will be appropriate when the criteria specified in the Call Report guidance are met.

4. An example of a restructured commercial real estate credit that does *not* have reasonable modified terms would be a mortgage that requires interest payments *only*, but no principal payments, despite the fact that the underlying collateral generates sufficient cash flow to pay both.

5. Some credits are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the credit based upon the guarantor's ability to repay the credit.

A guarantor's willingness to perform is assumed, unless there is evidence to the contrary. Since a guarantee is obtained with the intent of improving the repayment prospects of a credit, a guarantor may add sufficient strength to preclude or reduce the severity of the risk assessment.

Examiners should consider and analyze the following guarantee-related factors during the course of their review of extensions of credit:

- The degree to which the guarantors have demonstrated their ability and willingness to fulfill previous guarantees.
- Whether previously required performance under guarantees was voluntary or was the result of legal or other actions by the lender. Examiners should give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee under review.
- The economic incentives for performance by guarantors. This includes—
  - — guarantors who have already partially performed under the guarantee;
  - — guarantors who have other significant investments in the project;
  - — guarantors whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or
  - — guarantees collateralized by readily marketable assets that are under the control of a third party.
- The extent to which guarantees are legally enforceable, although in general this is the only type of guarantee that should be relied upon.
  - — Collection of funds under a guarantee should not be subject to significant delays or undue complexities or uncertainties that might render legal enforceability questionable.
  - — Although the bank may have a legally enforceable guarantee, it may decide not to enforce it. The examiner's judgment should be favorably affected by previous extensions of credit evidencing the timely enforcement and successful collection of guarantees.
- The type of the guarantee. Some guarantees for real estate projects are limited in that they only pertain to the development and construction phases of a project. As such, these limited guarantees cannot be relied upon to support a troubled credit after the completion of these phases.

OFF-BALANCE-SHEET ITEMS

The principal off-balance-sheet credit-related transactions likely to be encountered during loan reviews are loan commitments, commercial letters of credit, and standby letters of credit. When evaluating off-balance-sheet credit transactions for the purpose of assigning a credit-quality rating, the examiner should carefully consider whether the bank is irrevocably committed to advance additional funds under the credit agreement. If the bank must continue to fund the commitment and a potential weakness exists that, if left uncorrected, may at some future date result in the deterioration of repayment prospects or the bank's credit position, the amount of the commitment may be categorized as special mention. If there is a well-defined weakness that jeopardizes repayment of a commitment, classification may be warranted. If an amount is classified, it should be separated into two components: the direct amount (the amount that has already been advanced) and the indirect amount(the amount that must be advanced in the future).

Loan Commitments

Loan commitments are defined as legally binding obligations to extend credit (other than in the form of retail credit cards, check credit, and related plans) for which a fee or other compensation is typically received. Different types of loan commitments vary based upon the nature of the credit granted. Loan-commitment credit risk stems from the possibility that the creditworthiness of the customer will deteriorate between the time the commitment is made and the funds are advanced. (See "Contingent Claims from Off-Balance-Sheet Activities," section 4110.1.)

Commercial Letters of Credit

Commercial letters of credit involve a buyer of goods and a seller of goods and are instruments issued by a bank serving as an intermediary between the two for the resultant payment for the goods. Commercial letters of credit are customarily used to facilitate international trade due to the distances involved, as well as differences in legal, political, and business practices. Additionally, there may be a lack of familiarity between the buyer and seller. As a result, the bank substitutes its credit in place of the buyer's credit and promises on behalf of its customer to pay predetermined amounts of money to the seller against the delivery of documents indicating shipment of goods and representing title to those goods. If the shipping documents are in order, the bank is obligated to pay the seller through the issuance of a sight or time draft. The bank is then reimbursed by its customer for the amount of the shipment plus a fee for conducting the transaction.

Given the nature of the bank's commitment to pay for the goods on behalf of its customer, a commercial letter of credit is typically irrevocable. This means that it cannot be cancelled or revoked without the consent of all parties concerned. As a result, there is added credit risk for the issuing bank since it cannot cancel its commitment in the event the credit standing of its customer deteriorates, even if the deterioration occurs before the shipment of the goods.

Standby Letters of Credit

Most standby letters of credit (SLCs) are unsecured and involve substituting the bank's credit standing for that of the bank's customer on behalf of a beneficiary. This occurs when the beneficiary needs to ensure that the bank's customer is able to honor its commitment to deliver the goods or services by the agreed-upon time and with the agreed-upon quality. For credit-analysis purposes, SLCs are to be treated like loans and represent just one type of extension of credit relative to the overall exposure extended by the bank to the borrower. SLCs can be divided into two main groups: "financial SLCs" and "nonfinancial SLCs." Financial SLCs essentially guarantee repayment of financial instruments and are commonly used to "guarantee" payment on behalf of customers, issuers of commercial paper, or municipalities (relative to tax-exempt securities). Nonfinancial SLCs are essentially used as bid and performance bonds to "guarantee" completion of projects, such as building or road construction, or to guarantee penalty payment in case a supplier is unable to deliver goods or services under a contract.

REQUIRED LOAN WRITE-UPS

A full loan write-up (see criteria below) is required for all significant or material classified or specially mentioned assets if (1) management disagrees with the disposition accorded by the examiner, or (2) the institution will be rated composite 3, 4, or 5. The write-ups will be used to support the classifications to management and, in the case of problem banks, to support any necessary follow-up supervisory actions.

An abbreviated write-up may be appropriate for other loans to illustrate a credit-administration weakness or to formalize certain decisions, document agreements, and clarify action plans for management. For example, bank management may have agreed to either collect or charge off a loan classified doubtful by the next call report date or to reverse interest accruals and place the loan on nonaccrual status. These agreements may be expressed in the report through a brief comment under the classification write-up.

The examiner may find it beneficial to list extensions of credit alphabetically by department and/or branch. When more than one borrower is relevant to a single write-up, the alphabetization of the prime borrower or the parent corporation should determine the credit's position in the list. All other parties to the credit, including cosigners, endorsers, and guarantors, should be indicated directly under the maker of the notes or embodied within the write-up.

Although classifications and items listed for special mention may be listed alphabetically on the report page, examiners may elect to format the listing or write-ups in other ways to illustrate examination findings or conclusions. For example, examiners may wish to group classifications into categories of weakness and to use these listings to support loan-administration comments without providing a write-up for each classified item.

Notwithstanding this guidance, examiners have the flexibility of writing up more than the criticized assets, including any special mention credits, if deemed necessary. The decision to increase the number of write-ups should be based on factors such as the overall financial condition of the bank, quality of the loan portfolio, or adequacy of loan portfolio administration.

It is important that a sufficient number of write-ups with appropriate content be provided to support the examiner's assessment of the bank's problem loans, leases, and other extensions of credit. The write-ups should also support any comments pertaining to credit-administration policies and practices as they relate to this component of the bank's loan portfolio.

General Guidelines for Write-Ups of Special Mention and Classified Extensions of Credit

Extension of credit write-ups may be in a narrative or bullet format, similar to the write-ups of shared national credits, where appropriate. When the special mention or classified credit consists of numerous extensions of credit to one borrower, or when multiple borrowers are discussed in one write-up, the write-up should be structured to clearly identify the credit facilities being discussed. For example, each extension of credit could be numbered when multiple credits are involved.

Before a write-up is prepared, the examiner should recheck central information files or other sources in the bank to determine that all of the obligor's debt, including related debt,[6] has been noted and included. The examiner should consider identifying accrued interest receivable as special mention or classified, especially when the cumulative effect on classified percentages is significant or the accrued interest is appropriately classified loss.

Even though the length of a write-up may be limited, the information and observations contained in the write-up must substantiate the credit's treatment as a special mention or classified credit. To prepare a write-up that brings out pertinent and fundamental facts, an examiner needs to have a thorough understanding of all the factors relative to the extension of credit. An ineffective presentation of the facts weakens a write-up and frequently casts doubt on the accuracy of the risk assessment. The examiner might consider emphasizing deviations from prudent banking practices as well as loan policy and procedure deficiencies that are pertinent to the credit's problems. When portions of a borrower's indebtedness are assigned to different risk categories, including portions identified as "pass," the examiner's comments should clearly set forth the reason for the split-rating treatment. A full write-up on items adversely classified or listed as special mention must provide sufficient detail to support the examiner's judgment concerning the rating assigned. To ensure that the write-ups provide a clear, concise, and logical discussion of material credit weaknesses, the following minimum categories of information should be presented, preferably in the order listed (see SR-99-24):

1. *A general description of the obligation.*
   - *Amount of exposure (both outstanding and contingent or undrawn) as follows:*
     - — Summarize total related and contingent borrowings, including amounts previously charged off and recovered.
     - — List the borrower's total related liabilities outstanding. Amounts making up this total refer to credits in which the borrower may have a related interest and is directly or indirectly obligated to repay, such as partnerships and joint ventures. The rule for determining what is included in related debt (aggregating debt), which ultimately has to do with ascertaining compliance with legal lending limits, is governed by state law.
     - — List and identify the obligor's contingent liabilities to the bank under examination. Contingent liabilities include items such as unadvanced portions of a line of credit or extension of credit (commitments), guarantees or endorsements, and commercial and standby letters of credit. Although contingent liabilities to other lenders represent an important component of the financial analysis of the obligor, they should not be listed in the write-up unless they are particularly relevant to the situation, or are portions of both related and contingent liabilities that represent participations purchased from and sold to other lenders. The latter example should be listed even though the entire relationship may not have been identified as special mention or classified. Additionally, only the clas-

6. The term "related" refers to direct and indirect obligations.

sified portion of extensions of credit or contingent liabilities of the bank under examination should be listed in the appropriate column(s) of the classified asset page.

- *The obligor and the obligor's location and type of business or occupation.* For the type of business or occupation of the obligor, indicate whether the business is a proprietorship, partnership, joint venture, or corporation. This information can be used to compare the purpose of the credit with the source(s) of repayment, and to compare the credit's structure with the obligor's repayment ability. The general identification of occupation, such as professional or wage earner, may not be definitive enough, so it may be necessary to indicate that, for example, the extension of credit is to a medical doctor.

  Types of businesses may be clearly indicated in the borrower's business name and may not require additional comment. For example, Apex Supermarket and Ajax Sporting Goods Store imply a retail supermarket and a retail sporting goods store. However, examiners should not be misled in their analysis of the credit; likewise, the write-up reviewer should not be misled by assuming that a borrower is necessarily in the same line of business indicated by the borrower's business name. In the preceding example, if the borrower is primarily a wholesale grocery or sporting goods supplier, or if it radically deviates from the type of business indicated in its business name, the situation should be clarified. It is important to state the borrower's position in the marketing process—manufacturer, wholesaler, or retailer—and to indicate the types of goods or services.
- *Description and value of collateral.* The type of lien, collateral description and its condition and marketability, as well as the collateral's current value, date of valuation, and basis for the valuation, should be included. If values are estimated, the write-up should indicate the source of the valuation, such as the obligor's recent financial statement, an independent appraisal, or an internal management report. If valuations are not available, a statement to that effect should be included. A bank's failure to obtain collateral valuations, when available, is cause for criticism. Also include any other pertinent information that might impede or facilitate the possible sale of the collateral to repay the extension of credit.

  When problem borrowers are involved, the sale of the collateral often becomes the sole or primary source of repayment. As a result, the valuation of the collateral becomes especially important when describing the credit, as described in the specific examples below.

  If real estate is pledged to secure the credit, the write-up should provide a description of the property, the lien status, the amount of any prior lien, and the appraised value. If multiple parcels are securing the credit, appraised values should be listed for each parcel, including the date of the appraisal and the basis for the value. When bank staff or examiners' challenges to appraisal assumptions are supported, the resulting adjustment in value for credit-analysis purposes should be indicated. If the property held as collateral has tenants, its cash flow should be noted and the financial strength of the major lessees commented upon, if appropriate.

  If the collateral represents shares of or an interest in a closely held company, the shares or ownership interest held should be indicated in relation to the total shares outstanding, and the financial condition of the closely held company should be summarized in the write-up. Additionally, the approximate value of the closely held company, as indicated by its financial statements, should be compared for consistency with the value of the company as indicated on the principal's or partner's personal financial statement. The values often do not correlate to the extent they should, which typically indicates overvaluation of the asset on the balance sheet of the entity owning the shares or ownership interest.

  If a blanket lien on assets, such as receivables, inventory, or equipment, is pledged as collateral, the current estimated value of each asset type should be shown separately. The basis for these values can come from various sources, which should be indicated:

  — If receivables are pledged as collateral for an asset-based extension of credit, a current aging report and an assessment of the appropriateness of the advance ratio is usually necessary to determine their collectibility and value.

— If inventory is pledged as collateral for an asset-based extension of credit, an assessment of the appropriateness of the advance ratio is necessary. Additionally, the value varies with the condition and marketability of the inventory.

— If listed securities or commodities are pledged as collateral, the market value and date of valuation should be noted.

- *Notation if borrower is an insider or a related interest of an insider.*
- *Guarantors and a brief description of their ability to act as a source of repayment.* If the financial strength of guarantors has changed significantly since the initial guarantee of the credit facility, this should be noted. The relationship of the guarantors to the borrower should be identified, including a brief description of the guarantors' ability (financial strength) to serve as a source of repayment independent of the borrower. Any collateral supporting the guarantees should also be stated. See the previous subsection, "Role of Guarantees," for further guidance on considering guarantees for credit-analysis purposes.
- *Amounts previously classified.*
- *Repayment terms and historical performance, including prior charge-offs, and current delinquency status (with notation if the credit is currently on nonaccrual status).* Any changes to the original repayment terms, whether initiated by bank management or the obligor, should be detailed with an appropriate analysis of the changes included in the write-up. Renewals, extensions, and rewritten notes that deviate from the stated purpose and repayment expectations, as approved by management, should be discussed in light of their effect on the quality of the credit. Restructurings should be discussed in terms of their reasonable objectives, focusing on the prospects for full repayment in accordance with the modified terms.

It may be prudent to state the purpose of the credit. The purpose can be compared with the intended source of repayment for appropriateness. For example, a working capital extension of credit generally should not depend on the sale of real estate for repayment. Additionally, the obligor's prior business experience should correlate to the credit's purpose.

2. *A summary listing of weaknesses resulting in classification or special mention treatment.*
3. *A reference to any identified deficiencies in the item that will support loan-administration or violation comments elsewhere in the report.* This information may consist of deficiencies in credit and collateral documentation or violations of law that have a material impact on credit quality. Loan-portfolio-administration performance includes, but is not limited to—
   - changes in asset quality since the last examination;
   - the appropriateness of loan-underwriting standards;
   - the adequacy of—
     - — loan documentation;
     - — management information systems;
     - — internal control systems; and
     - — loan-loss reserves;
   - the accuracy of internal loan-rating systems;
   - the ability and experience of lending officers, as well as other personnel managing the lending function; and
   - changes in lending policies or procedures since the last examination.
4. *If management disagrees with the classification, a statement to that effect along with management's rationale.* Information could include selected data from the most recent fiscal and interim financial statements (discussion of items such as leverage, liquidity, and cash flow) when the primary reason for the write-up relates to the borrower's financial condition or operating performance. Cost of goods sold, nonrecurring expenses, dividends, or other items indicating deterioration in the credit quality may also be highlighted. Any stated value of the borrower's encumbered assets should be set off against specific debt to arrive at the unprotected balance, if applicable. In addition, the examiner should identify encumbered assets that are pledged elsewhere.
5. *A concise description of any management action taken or planned to address the weakness in the asset.* The action plan should focus on a concise description of management's workout or action plan to improve the credit's collectibility or to liquidate the debt. Review of the bank's documented workout plan should give an examiner a clear idea of past efforts to improve the prospect of col-

lectibility and management's current efforts and future strategy. The plan should clearly state the bank's goals and corresponding timetable as they appear at that point, including items such as the degree of repayment envisioned and the proceeds anticipated from the sale of the collateral. Based on this information, the examiner should succinctly summarize in the write-up the bank's collection efforts to date and its ongoing plans to address the situation.

Optional Information for Write-ups

At the examiner's discretion, other information may be included in loan write-ups. For example the examiner may want to include current financial information on the borrower, cosigners, and guarantors. The additional information may consist of discussions regarding current balance sheets and operating statements. If discussed, the examiner should indicate whether the financial statements have been audited, reviewed, compiled, or prepared by the borrower, and whether they are fiscal or interim statements. If the statements are audited, the examiner should indicate the type of opinion expressed—unqualified, qualified, disclaimer, or adverse—and whether the auditor is a certified public accountant. If the opinion is qualified, note the reason(s) given by the auditor.

When the examiner includes comments regarding the borrower's financial condition, the comments should always highlight credit weaknesses in a manner that supports the risk assessment. It is important that sufficient detail is provided to identify unfavorable factors. A trend analysis or details of balance-sheet, income-statement, or cash-flow items can be included. The examiner may also include comments when special mention or classified credits may exhibit favorable as well as unfavorable financial characteristics. Both types of pertinent factors may be included in the write-up as long as they are placed in the proper perspective to demonstrate the credit's inherent weaknesses.

OVERVIEW

This section will help the examiner perform two separate, but related, functions:

- evaluate the depth and scope of the formalized policies and procedures the bank uses to manage and control its loan portfolio
- form an overview of the performance of the entire lending operation by consolidating the results of the examination programs from the various lending departments

BANK LOAN POLICY

The purpose of a bank's lending policy is to establish the authority, rules, and framework to operate and administer its loan portfolio effectively, that is, to ensure profitability while managing risk. The policy serves as a framework to set basic standards and procedures in a clear and concise manner. The policy's guidelines should be derived from a careful review of internal and external factors that affect the institution, such as the bank's market position, historical experience, present and prospective trade area, probable future loan and funding trends, facilities, staff capabilities, and technology. Such guidelines, however, must be void of any discriminatory policies or practices.

The complexity and scope of the lending policy and procedures should be appropriate to the size of the institution and the nature of its activities and should be consistent with prudent banking practices and relevant regulatory requirements. Examiners should keep in mind that a loan policy that is appropriate for one bank is not necessarily suitable for another bank. Each bank's policy will differ, given the institution's strategic goals and objectives, coupled with factors such as economic conditions, the experience and ability of the lending personnel, and competition. The policy should be reviewed at least annually to ensure that it is not outdated or ineffective, remains flexible, and continues to meet the needs of the community. Changes in federal and other regulatory requirements, including limitations involving insider transactions, also must be incorporated into the policy.

The policy should be broad and not overly restrictive. If carefully formulated and administered by senior management, and clearly communicated and understood through each level of the organization, it greatly helps bank management (1) maintain sound credit-underwriting standards; (2) control and manage risk; (3) evaluate new business opportunities; and (4) identify, administer, and collect problem loans.

The lending policy must clearly state the philosophies and principles that govern safe and sound banking practices and procedures, as well as the mission and objectives of the particular institution. Throughout this manual, considerable emphasis is placed on formal written policies established by the board of directors that management can implement, administer, and amplify. The board of directors, in discharging its duty to both depositors and shareholders, must ensure that loans in the bank's portfolio are made based on the following three objectives:

- to grant loans on a sound and collectible basis
- to invest the bank's funds profitably for the benefit of shareholders and the protection of depositors
- to serve the legitimate credit needs of the bank's community

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy promotes—

- a bank's business and lending philosophy, despite changes in management;
- stability, as it provides a reference for lenders;
- clarity, to minimize confusion concerning lending guidelines; and
- sound objectives for evaluating new business opportunities.

The loan policy should define who will receive credit, what type, and at what price, as well as what credit documentation will be permitted or required. Other internal factors to be addressed include who will grant the credit and in what amount, as well as what organizational structure will ensure compliance with the bank's guidelines and procedures. Because loan authority is spread throughout the organization, the bank must have an efficient internal review and reporting system to monitor adherence to established guidelines. This system should adequately inform the directorate and senior management of how policies are being carried out and should provide them with sufficient information to evaluate the performance of lending officers and the condition of the loan portfolio.

The loan policy should establish (1) what information will be required from the borrower during the application process, (2) what information the borrower will be required to submit while the credit remains outstanding, and (3) which bank personnel are responsible for obtaining the information. In addition, the policy should specify who is responsible for reviewing the adequacy of loan documentation and for citing and correcting documentation exceptions. A high level of documentation exceptions indicates a deficiency in the bank's policy, procedures, monitoring, or enforcement.

A loan policy will differ from loan procedures. A policy represents a plan, guiding principle, or course of action designed to establish a framework for handling decisions, actions, and other matters, thereby influencing them. A procedure is a set of established methods or steps for performing a task. The lending policy should include issues relevant to all departments of the bank. Written procedures approved and enforced in various departments should be referenced in the bank's general lending policy. The policy must be flexible enough to allow for fast adaptation to changing conditions in the bank's earning assets mix and trade area.

Components of a Sound Lending Policy

As mentioned previously, a bank's loan policy should be appropriate to its size and complexity. Sound loan policy generally is based on the components described below.

Allowance for loan and lease losses. A sound lending policy establishes a systematic loan-review program to detect and identify problem loans and other portfolio weaknesses. (See the "Credit Risk Review" subsection for more information.) Guidelines and methodologies need to be established to determine the adequacy of the bank's allowance for loan and lease losses (ALLL), and they should be based on a conservative analysis of the risk in the loan portfolio. This analysis should ensure that an appropriate ALLL is maintained. The 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses[1] stipulates that federally insured depository institutions (IDIs) must maintain an ALLL at an appropriate level to absorb estimated credit losses associated with the loan and lease portfolio.

Examiners must evaluate management's estimate of losses existing in the bank's loan portfolio as well as the methodologies and procedures used in making and documenting the estimate. That evaluation provides the basis for determining the appropriateness and reasonableness of a bank's ALLL.

Collections and charge-offs. The lending policy should define the criteria and procedures for reporting relevant information concerning delinquent obligations to the board of directors. The policy should establish the mechanism for presenting problem loans to the directorate. Reports submitted to the board of directors should include sufficient detail for it to determine the risk factor, loss potential, and alternative courses of action. The policy should outline a follow-up collection notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board of directors or a board committee for charge-off.

Concentrations of credit. The lending policy should encourage both diversification within the portfolio and a balance between maximum yield and minimum risk. Concentrations of credit depend heavily on a key factor, and when weaknesses develop in that key factor, every individual loan within the concentration is affected. The directorate should evaluate the additional risk involved in various concentrations and determine which concentrations should be avoided or limited. The lending policy also should establish thresholds for acceptable concentrations of credit and require that all concentrations be reviewed and reported to the board on a periodic basis.

Institutions that have effective controls to manage and reduce undue concentrations over time need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. This principle applies to prudent loan renewals and rollovers, as well as

1. See SR-06-17 and SR-01-17. *See also,* SR-20-12, for more information on the allowance for credit losses.

to new extensions of credit that are underwritten in a sound manner. (See the "Concentrations of Credit" section for further details.)

Consumer and equal credit opportunity laws. Compliance with the many consumer-related statutes and regulations requires complex and detailed policies and procedures that should be addressed in a separate policy. However, the loan policy should require adherence to the Federal Reserve's Regulation B, 12 CFR 202, which implements the Equal Credit Opportunity Act. This regulation prohibits creditors from discriminating against loan applicants on the basis of age, race, color, religion, national origin, sex, marital status, or receipt of income from public assistance programs. As additional prohibitions are added under the regulation, they should be incorporated into the policy. Also, the loan policy should include a requirement that the bank give applicants a written notification of rejection of a loan application, a statement of the applicant's rights under the Equal Credit Opportunity Act, and a statement either of the reasons for rejection or of the applicant's right to such information.

Credit files. Obtaining and maintaining complete and accurate information on every relevant detail of a borrower's financial condition is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowing relationships, regardless of size, with the exception of the latitude provided by the Interagency Policy Statement on Documentation of Loans. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to analyze the credit before it is granted and to monitor and evaluate the credit during its life. Such information should (1) identify the borrower's business or occupation; (2) document the borrower's past and current financial condition; (3) state the purposes of all loans granted to the borrower, the sources of repayment, and the repayment programs; and (4) identify the collateral and state its value and the source of the valuation.

Credit files should include all financial statements, credit reports, collateral-inspection documents, reference letters, past loan applications, memoranda, correspondence, and appraisals. In many cases, particularly those involving real estate loans, appraisals and other collateral documentation may be maintained in a separate collateral file.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, a bank may not require financial statements from borrowers whose loans are fully secured by certificates of deposit it issues. In a more general sense, information requirements between amortizing consumer loans and commercial or real estate loans vary greatly. More specific examples of the types and frequency of financial information often obtained for various types of credit are detailed in the following paragraphs.

For many consumer installment and residential mortgage loan borrowers, the borrowers' financial information generally is collected only at the time of loan application. The underwriting process for these types of loans emphasizes factors such as the borrower's income and job stability, credit history, and debt load, as well as the loan-to-value requirements for obtained collateral.

In factoring and other asset-backed lending activities, while financial information is a significant part of the underwriting process, collateral is the key component of the lending decision. Close monitoring of the collateral's existence, value, and marketability are essential to sound underwriting of these types of loans.

For typical commercial, commercial real estate, and agricultural loans, significant emphasis is placed on the financial strength, profitability, and cash flow of the core business for loan repayment. Close monitoring of the business's financial condition and profitability throughout the life of the loan is key to the sound administration of these types of credits. Other pertinent information requirements, such as collateral-inspection documentation for agricultural credits or lease/rental information for income-producing commercial real estate credits, may also be necessary to properly administer these loans. As part of the sound underwriting process for these loans, a bank may include loan covenants requiring the business to maintain financial soundness, submit periodic financial statements, and provide other needed information.

As a practice, a bank should not ask for information it does not need to adequately underwrite and monitor the quality of its loans. With proper use of loan covenants, a bank can protect its right to receive additional or more frequent information if a borrower's financial condition deteriorates or collateral values decline. When determining the financial and other information to request from the borrower, bankers should consider the requirements of the underwriting process for particular types of loans and the repayment risks. A bank's loan policy should clearly delineate the type and frequency of such information requirements.

The lending policy also should define the financial-statement requirements for businesses and individuals at various borrowing levels. Specifically, requirements for audited, unaudited, annual, or interim balance sheets; income and cash-flow statements; statements of changes in capital accounts; and supporting notes and schedules should be included, as appropriate. In addition, the lending policy should require external credit checks as appropriate, at the inception of the loan and during periodic updates. The loan policy should be written so that credit-data exceptions would be a violation of the policy.

Distribution by category. Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Aggregate percentages for loans to deposits, assets, and capital (with regard to concentrations of credit) would provide guidance for effective portfolio management. Such policies are beneficial but should allow for deviations, with the approval by the board or a board committee. This allows credit to be distributed in response to the community's changing needs. During times of heavy loan demand in one category, an inflexible loan-distribution policy would cause that category to be slighted in favor of another.

Exceptions to the loan policy. A lending policy should require loan officers to present credits they believe are fundamentally sound and worthy of consideration, even though they may not conform with the bank's written lending policy or procedures. The reason for the exception should be detailed in writing and submitted for approval to a designated authority. The directors' loan committee or a similar body should review and approve all exceptions at reasonable intervals. The frequency of exceptions granted may indicate a lessening of underwriting standards on the one hand, or a need to adjust the policy to allow flexibility within safe and sound parameters on the other. The underlying reasons behind frequently granted exceptions should be assessed, and appropriate recommendations should be made accordingly.

Financing other real estate. If the bank wants to finance a parcel of other real estate that it owns, special accounting rules may apply. Consequently, the lending policy should include an outline of certain provisions of Financial Accounting Standards Board (FASB) Statement No. 66, "Accounting for Sales of Other Real Estate."

Geographic limits. A bank's trade area should be clearly delineated and consistent with defined Community Reinvestment Act (CRA) criteria. Loan officers and directors should be fully aware of specific geographic limitations for lending purposes. The bank's defined trade area should not be so large that, given its resources, the bank cannot properly and adequately monitor and administer its credits. A sound loan policy restricts or discourages loan approval for customers outside the trade area. The bank's primary trade area should be distinguished from any secondary trade area, which is especially important for new banks. Specific restrictions or exceptions should be listed separately.

Lender liability. Banking organizations must be careful that their actions to make, administer, and collect loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). (See the "Environmental Liability" subsection.)

Limitation on aggregate outstanding loans. Banks should establish guidelines limiting the total amount of loans outstanding in relation to other balance-sheet accounts. This type of control over the loan portfolio usually is expressed relative to deposits and total assets. In setting such limitations, various factors, such as the credit demands of the community, the volatility of deposits, and the credit risks involved, must be considered.

Loan authority. The lending policy should establish limits for all lending officers and ensure controls are in place to monitor compliance with the bank's legal lending limit. An individual officer's lending limit is usually based on his or her experience, tenure, and past adherence to the bank's loan policy. Lending limits also should be set for group authority, thereby allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The loan policy should describe the manner in which loans will be approved and ultimately reported to the board of directors, as well as the frequency of any loan committee meetings, as applicable.

Loan pricing. Interest rates on loans should be sufficient to cover (1) the cost of the funds loaned, (2) the bank's loan services (including general overhead), and (3) probable losses—while providing for a reasonable profit margin. In setting interest rates a bank considers the costs for its various loan products. Periodic review allows rates to be adjusted in response to changes in costs, competitive factors, or risks of a particular type of extension of credit. Specific guidelines for other relevant factors, such as compensating-
balance requirements and fees on commitments, are also germane to pricing credit.

Loan purchases and sales. If sufficient loan demand exists, lending within the bank's trade area is safer and less expensive than purchasing paper from a dealer or a correspondent bank. Direct lending promotes customer relationships, serves the credit needs of customers, and develops additional business. Occasionally, a bank may not be able to advance a loan to a customer for the full amount requested because of individual state lending limitations or other reasons. In such situations, the bank may extend credit to a customer up to its internal or legal lending limit and sell a participation to a correspondent bank for the amount exceeding the bank's lending limit or the amount it wishes to extend on its own. Generally, such sales arrangements are established before the credit is ultimately approved. These sales should be on a nonrecourse basis by the bank, and the originating and purchasing banks should share in the risks and contractual payments on a pro rata basis. Selling or participating out portions of loans to accommodate the credit needs of customers promotes goodwill and enables a bank to retain customers who might otherwise seek credit elsewhere.

Conversely, many banks purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with affiliates or members of a chain-banking organization, with the goal of benefiting the whole organization. A purchasing bank may also wish to supplement its loan portfolio when loan demand is weak. In still other cases, a bank may purchase or participate in a loan to accommodate an unrelated originating bank with which it has an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a bank diversify its risks and improve its liquidity.

Banks should avoid purchases of loans that generate unacceptable concentrations of credit. Such concentrations may arise solely from the bank's purchases, or they may arise when loans or participations purchased are aggregated with loans originated and retained by the purchasing bank. The policy should state the limits (1) for the aggregate amount of loans purchased from and sold to any one outside source and (2) of all loans purchased and sold. It should also establish limits for the aggregate amount of loans to particular types of industries. The extent of contingent liability, holdback and reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, the policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the bank itself. Guidelines should be established for the type and frequency of credit and other information the bank needs to obtain from the originating institution to keep itself continually updated on the status of the credit. Guidelines should also be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the bank.

Prohibition on asset purchases or sales. The Dodd-Frank Act amended the Federal Deposit Insurance Act (FDIA) to impose a prohibition on asset purchases and 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 in advance by a majority of the members of the board of directors of the IDI who do not have an interest in the transaction. See section 18(z) of the FDIA, as amended by the Dodd-Frank Act, section 615(a).

Loans to employees, officers, directors, principal shareholders, and their related interests. Loans to insiders are strictly defined in federal statutes and require close supervision to ensure compliance. Federal and state statutes provide the basis for defining insider loans, and they specify requirements and limitations that should be incorporated in the policy. (See the Federal Reserve's Regulation O, 12 CFR 215.)

The policy should ensure, through a system of controls over authority and funding, that transactions and extensions of credit to insiders are legally permissible and that they are made on substantially the same terms and conditions as those prevailing at the time for comparable transactions with other borrowers. Furthermore, the policy should contain guidelines for loans to employees who are not subject to the provisions of Regulation O.

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

Maximum ratio of loan amount to collateral value. The loan policy should set forth procedures for ordering, preparing, and reviewing appraisals for real or personal property pledged as collateral. The bank's lending policy should outline guidelines for appraisals or internal evaluations, including regulatory requirements, and, in the case of renewals or extensions, procedures for possible reappraisals or re-evaluations. Acceptable types of appraisals or evaluations should be outlined. Circumstances requiring the use of in-house staff appraisers instead of fee appraisers should be identified. Maximum loan-to-value ratios and the methods of valuation to be used for various types of collateral should be detailed. (See the "Real Estate Loans" and "Real Estate Construction Loans" sections for further details.)

The maximum ratio of loan amount to the market value of pledged securities is restricted by the Federal Reserve's Regulation U, 12 CFR 221. The lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security, that is, whether it is actively traded, over the counter, or closely held. The policy also should assign responsibility and set a frequency for periodic pricing of the collateral.

Prohibitions against tying arrangements. The most common types of tying arrangements are those where a bank product or consideration for a bank product is conditioned upon obtaining another product from the bank or an affiliate. Section 106 of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from tying a product or service to any of its other products or services, including those offered by its affiliates.[2] Examiners should ascertain that member banks have not extended credit voluntarily or involuntarily based on impermissible tying arrangements.

Types of loans. The lending policy should state the types of loans management considers desirable or prohibited. It also should set forth guidelines for extensions-of-credit types such as commercial loans; real estate loans; secured and unsecured loans; and off-balance-sheet activities, such as letters of credit and loan commitments. The decision about the types of loans granted should be based on the expertise of the lending officers, the deposit structure of the bank, and the community's anticipated credit demands. Credits involving complex structures or repayment arrangements, or loans secured by collateral that requires more-than-normal monitoring, should be avoided unless the bank has the personnel, policies, controls, and systems necessary to administer such advances properly. Types of credits that have caused an abnormal loss to the bank should be identified, scrutinized, and controlled within the framework of stated policy. A bank also should consider its overall

2. For more information, see this manual's section entitled, "Regulation Y: Prohibitions Against Tying Arrangements."

exposure to term lending relative to its stable funds.

Continued rigorous credit-risk assessment during favorable economic conditions. Internal processes and requirements for loan-underwriting decisions should be consistent with the nature, size, and complexity of the banking organization's activities and with the institution's lending policies. Any departures therefrom can have serious consequences for institutions of all sizes. Departures can be evident in three pivotal and related areas:

1. *An undue reliance on optimistic outlooks for prospective borrowers and for continued favorable economic and financial market conditions.* A long and continuing economic expansion can lead banks to more frequently base their decision to lend on a very optimistic assessment of the borrower's operating prospects. Timely principal repayment may often be based on the assumption that the borrower will have ready access to financial markets in the future. Such reliance, especially if across a significant volume of loans, is not consistent with sound credit-risk management. Undue reliance on continued favorable economic conditions can be demonstrated by—

   - dependence on very rapid growth in a borrower's revenue as the "most likely" case;
   - heavy reliance on favorable collateral appraisals and valuations that may not be sustainable over the longer term;
   - greater willingness to make loans without scheduled amortization before the loan's final maturity; or
   - ready willingness to waive violations of key covenants, release collateral, or guarantee requirements, or even to restructure loan agreements, without corresponding concessions on the part of the borrower on the assumption that a favorable environment will allow the borrower to recover quickly.

   Among the adverse effects of undue reliance on a favorable economy is the possibility of delay in properly identifying problem loans. Timely identification of problem loans is critical for providing a full awareness of the institution's risk position, informing management and directors of that position, taking steps to mitigate risk, and properly assessing the adequacy of the allowance for credit losses and capital.[3]

   Underlying a banking organization's (BO) overly optimistic assessment of a borrower's prospects may be an overreliance on its continued ready access to financial markets on favorable terms. Examples of overreliance include the following:

   - explicit reliance on future, public market debt or equity offerings or on other sources of refinancing as the ultimate source of principal repayment, which presumes that market liquidity and the appetite for such instruments will be favorable at the time that the facility is to be repaid
   - ambiguous or poorly supported BO analysis of the repayment sources of the loan's principal (This results in an implicit reliance, for repayment, on some realization of the implied market valuation of the borrower (for example, through refinancing, asset sales, or some form of equity infusion) and presumes, as above, that markets will be receptive to such transactions at the time that the facility is to be repaid.)
   - measuring a borrower's leverage (for example, debt-to-equity) based solely on the market capitalization of the firm without regard to "book" equity, and thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed
   - more generally, extending bank loans with a risk profile that more closely resembles that of an equity investment and under circumstances in which additional bank credit or default are the borrower's only resort if favorable expectations are not met

   As a result of this overreliance, some banking organizations may find themselves with a potentially significant concentration of credit exposure that is at risk to a possible reversal in financial markets. Turmoil in financial markets, however, may contribute to signifi-

3. With respect to these issues, see SR-98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Rating Systems at Large Banking Organizations." As discussed therein, the Federal Reserve's guidance on credit-risk management and mitigation covers both loans and other forms of on- and off-balance-sheet credit exposure.

cant liquidity pressures in some sectors of the economy and prevent ready access to financial markets by certain borrowers. Moreover, there is no assurance that any such market turmoil will quickly resolve itself. Under these circumstances, a borrower's ability to raise new funds in public debt or equity markets to repay maturing bank loans is far from guaranteed.

2. *Insufficient consideration of stress testing.* An institution's lending policies should prescribe meaningful stress testing of the prospective borrower's ability to meet its obligations. Failure to recognize the potential for adverse events—whether specific to the borrower or its industry (for example, a change in the regulatory climate or the emergence of new competitors) or to the economy as a whole (for example, a recession)—can prove costly to a banking organization.

   Mechanical reliance on threshold financial ratios (and the "cushion" they imply) is generally not sufficient, particularly for complex loans and loans to leveraged borrowers or others that must perform exceptionally well to meet their financial obligations successfully. Scenario analysis specific to the borrower, its industry, and its business plan is critical to identify the key risks of a loan. Such analysis should have a significant influence on both the decision to extend credit at all and, if credit is extended, on decisions on appropriate loan size, repayment terms, collateral or guarantee requirements, financial covenants, and other elements of the loan's structure.

   When properly conducted, meaningful stress testing includes assessing the effect on the borrower when the following situations or events occur:

   - unexpected reductions or reversals in revenue growth, including shocks to revenue of the type (or types) and magnitude that would normally be experienced during a recession
   - unfavorable movements in market interest rates, especially for firms with high debt burdens
   - unplanned increases in capital expenditures due to technological obsolescence or competitive factors
   - deterioration in the value of collateral, guarantees, or other potential sources of principal repayment
   - adverse developments in key product or input markets
   - reversals in or reduced access by the borrower to public debt and equity markets

   Proper stress testing typically incorporates an evaluation of the borrower's alternatives for meeting its financial obligations under each scenario, including asset sales, access to alternative funding or refinancing, or ability to raise new equity. In particular, the evaluation should focus not only on the borrower's ability to meet near-term interest obligations, but also on its ability to repay the principal of the obligation.

3. *Weakening of key internal controls in the lending process.* An institution's lending policy should require the use of adequate internal controls within the lending process. Internal controls such as loan review or credit audit are critical for maintaining proper incentives for bank staff to be rigorous and disciplined in their credit analysis and lending decisions. A bank's credit analyses, loan terms and structures, credit decisions, and internal rating assignments should be reviewed in detail by experienced and independent loan-review staff. These reviews provide both motivation for better credit discipline within an institution and greater comfort for examiners—and management—that internal policies are being followed and the institution continues to adhere to sound lending practice.

   Economic prosperity and relatively low levels of problem loans and credit losses should not encourage institutions to dramatically or suddenly reduce staff resources or portfolio coverage for the loan-review function. Likewise, thorough reviews of individual loans should continue. When economic prosperity and relatively low levels of problem loans and credit losses exist, there may be increasing internal pressure within the institution to reduce loan-review staff, to conduct more limited loan portfolio reviews, and to perform less thorough reviews of individual loans. Although some useful efficiencies may be desired, the danger is that the scope and depth of loan-review activities may be reduced beyond prudent levels over a longer horizon. If reduced too far, the integrity of the lending process and the discipline of identifying unrealistic assumptions and discerning problem loans in a timely fashion may deteriorate, particularly as a result of a downturn in a credit cycle.

Other. Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the bank's lending activities on its interest-rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to off-balance-sheet instruments that may be associated with lending arrangements, including commitments, letters of credit, or swaps. (See this manual's section on "Contingent Claims from Off-Balance-Sheet Credit Activities" for further details.)

Under the provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), a financial institution is required to develop, adopt, and maintain policies, procedures, and guidelines consistent with safe and sound banking practices. The federal banking agencies have issued interagency guidelines based on the provisions. Taken together, these guidelines should strengthen supervision of financial institutions and provide guidance in developing and maintaining policies:

- Regulation H—subpart E, 12 CFR 208.50–51
- Regulation Y—subpart G, 12 CFR 225.61–67
- Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation
- Interagency Appraisal and Evaluation Guidelines (See SR-10-16.)
- Interagency Policy Statement for Loan and Lease Losses (See SR-06-17.)
- Interagency Policy Statement on Supervisory Initiatives/Credit Availability (See SR-93-30.)
- Interagency Policy Statement on Documentation of Loans (See SR-93-26.)
- Regulation Y, section 225.7 "Tying Restrictions" (12 CFR 225.7.)

An institution's policies and procedures as they relate to interagency statements should be reviewed as part of the examination of the institution's overall lending activities.

GUIDANCE ON PRIVATE STUDENT LOANS WITH GRADUATED REPAYMENT TERMS AT ORIGINATION

Interagency[4] guidance[5] was issued on January 29, 2015, to provide financial institutions with principles applicable to private student loans that have graduated repayment terms. Financial institutions that originate private student loans may offer borrowers graduated repayment terms in addition to fixed amortizing terms at the time of loan origination. Graduated repayment terms are structured to provide for lower initial monthly payments that gradually increase. Refer to SR-15-2/CA-15-1 and its attachment.

Loan agreements include a grace period[6] to help with the post-education transition, the agencies and the State Liaison Committee recognize that students leaving higher education programs may prefer more flexibility to transition into the labor market because of a number of factors, such as competitive job markets, traditionally low entry-level salaries, and higher student debt loads. Graduated repayment terms may align borrowers' income levels with loan repayment requirements, provide flexibility to repay the debt sooner if borrowers' incomes increase more quickly than projected, and help long-term probability of full repayment.

Financial institutions that originate private student loans with graduated repayment terms should prudently underwrite the loans in a manner consistent with safe and sound lending practices. Financial institutions should provide disclosures that clearly communicate the timing and the amount of payments to facilitate a borrower's understanding of the loan's terms and features.

4. The agencies consist of the Board of Governors of the Federal Reserve System, Consumer Financial Protection Bureau, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency.

5. In implementing this guidance, the agencies will examine financial institutions consistent with their respective authorities.

6. A grace period is the allotted amount of time during which borrowers are not expected to make payments on student loans after initially leaving higher education programs or dropping below half-time enrollment status.

PROHIBITIONS AGAINST TYING ARRANGEMENTS

Among other things, section 106 of the Bank Holding Company Act Amendments of 1970 (section 106) prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank.[7] The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services. Although section 106 prohibits banks from imposing certain types of tying arrangements on their customers, the statute also expressly permits banks to engage in other forms of tying and authorizes the Board to grant additional exceptions to the statute's prohibitions by regulation or order. For more information on section 106, see this manual's section, "Regulation Y: Prohibitions Against Tying Arrangements."

LOAN ADMINISTRATION

Loan administration is a term that refers to several aspects of lending. It can be used to describe the entire credit-granting process, as well as the monitoring of various lending activities, such as ensuring that loans remain adequately collateralized, properly graded, and appropriately serviced (administered). The servicing of an extension of credit involves tasks ranging from obtaining current financial information to sending out renewal notices and preparing loan agreements. In addition to facilitating the entire lending process, the individual tasks also serve as controls (checks and balances) over the lending activities. Given the wide breadth of responsibilities that the loan-administration function encompasses, its organizational structure varies with the size and sophistication of the bank. In larger banks, responsibilities for the various components of loan administration are usually assigned to different departments, while in smaller institutions, a few individuals might handle several of the functional areas. For example, a large bank's independent credit department may be responsible for analyzing borrowers' financial information, making a determination or recommendation as to the quality of the loan (its risk rating or grade), or obtaining/following up on credit-related information and documentation. On the other hand, smaller banks may assign each of these tasks to individual loan officers.

Examiners will encounter many different organizational structures for loan administration. Therefore, when considering the safety and soundness of a bank, they should determine whether it has effective and appropriate internal controls in place. The assessment of loan administration and related internal controls involves evaluating the bank's operations by reviewing the—

- efficiency and effectiveness of loan-administration operations;
- ability of the different components to safeguard assets, primarily loans and leases;
- adequacy of the management information systems and the accuracy of their reporting;
- adequacy and accuracy of its loan-review function (discussed in the next subsection); and
- compliance with prescribed management policies and procedures as well as applicable statutes and regulations.

For the components of loan administration to function appropriately, management must understand and demonstrate that it recognizes the importance of controls. This includes not only establishing appropriate policies and procedures but also enforcing them and ensuring that the bank's organizational structure is suitable for its size and complexity. Managers should emphasize integrity and ethical values, as well as hire competent staff. In addition, the following factors positively influence loan-administration control:

- a board of directors and/or senior management that takes an active role in monitoring lending policies and practices
- a reporting system that provides the bank with the information needed to manage the lending function and make sound credit decisions
- a well-defined lending-approval and -review system that includes established credit limits; limits and controls over the types of loans made and their minimum collateral requirements (for example, loan-to-collateral-value ratios); limits on maturities of loans; and policies on interest rates, pricing, and fee charges

7. 12 U.S.C. 1972.

- an independent loan-review function that identifies and evaluates existing and potential problem loans in a timely manner
- an independent reporting system that notifies appropriate personnel when financial information, insurance policies, or other loan documentation needs to be obtained
- a system of procedures that correct documentation exceptions

Loan administration is responsible for mitigating the operational risks associated with loan-related transactions, such as approving credit, disbursing loan proceeds, receiving loan payments, recording accrued interest and fee income, posting to subsidiary ledgers, and reconciling subsidiary and general ledgers. Typically, employees working with these types of activities have the capability to transfer funds between accounts on the bank's and the customer's behalf, which opens up an area of potential abuse. Additional potential areas for unethical employee behavior include the maintenance of loan notes and related documentation, as well as the credit and collateral files on borrowers. The bank must ensure it has adequate controls in place to avoid any improprieties; controls might include having separate departments for loan activities within a large organizational structure or rotating and/or segregating loan duties in smaller community banks. Some specific issues related to these responsibilities are described below.

Applications and Loan-Approval Process

The bank should have written policies and procedures for obtaining and reviewing loan applications and for ensuring sufficient borrower information (both financial and collateral-related) is required and analyzed in support of the loan approval. Approvals should be made in accordance with the bank's written guidelines and should also address the disbursal of loan proceeds. Additional issues that bank policies and procedures should address include—

- the requirement that loan commitments be in writing;
- requirements for letters of credit;
- the requirement for an annual review of borrowers, including a reassessment of the appropriateness of credit lines; and
- the requirement for a process for extending or renewing loans and credit lines.

Exceptions to the bank's written policies and procedures should reflect the appropriate level of approval and should be documented in writing.

Account Records

Bank staff should compare the approved terms for new and renewed extensions of credit (amount, maturity, interest rate, payment schedule) to the note or loan agreement for accuracy. The former should then be compared with the trial balance, if it is automated. If a manual system is used, the approved amount of the extension of credit should be checked against deposit tickets to ensure the correct amount was transferred to the borrower's account. Adjustments to loan accounts or accrued interest receivable accounts should be checked and tested by an individual independent of the loan-processing area. Subsidiary records should be routinely reconciled with the appropriate general ledger accounts.

Payments

Regardless of the type of payment, principal, interest, or fee, certain controls are necessary to ensure the effectiveness of operations, as well as the safeguarding of bank assets. An individual who cannot originate loan entries should perform an independent test of interest, commissions, and fee computations to confirm their accuracy. Payment notices should be prepared by someone other than a loan teller. In addition, loan officers should be prohibited from processing loan payments. Payments received by mail, tellers, or other departments should be separate from the loan-recording function. Supervisory approvals should be required for processing payments that are less than the amount contractually due, pertain to delinquent loans, are received irregularly, or involve waiving late fees. Collection notices should also be handled by someone not associated with loan processing.

Credit File Documentation

The bank should establish and maintain credit files for all borrowers. The bank's written loan policy should detail the minimum acceptable amount of information to be included in a borrower's credit file. The credit file should contain information on the extension of credit that identifies its purpose, source of repayment, repayment terms, and disposition of loan proceeds. Additionally, information should be on file relating to and/or analyzing the borrower's financial condition, including tax returns as appropriate; collateral, its valuation and related hazard insurance; the loan officer's contact with the borrower; and other pertinent documents, such as guarantor information, loan agreements, and loan covenant check sheets. Banks should maintain this information to support their evaluation of the borrower's creditworthiness and to leave a paper trail for auditors. The bank should also implement a file documentation tickler system to help bank personnel obtain updated information on borrowers, thereby facilitating continuous assessment and monitoring of credit risk.

Collateral Records

Banks should maintain appropriate documentation on collateral received from and released to borrowers, which should be consistent with the underlying loan agreements. Negotiable collateral, such as stock certificates, should be maintained under dual control in a fireproof vault. The receiving and releasing of collateral to customers should be handled by individuals other than those who make entries in the collateral register. The bank should issue a receipt to customers for each item of collateral it is holding in safekeeping. Signed customer receipts should be obtained and filed after the collateral is released.

Management Information Systems

Management information systems, an increasingly important component of the loan administration function, allow a bank to manage its lending decisions more efficiently and effectively. Whether the bank uses a computerized or manual system to manage its loan portfolio, the following types of information should be readily available and routinely reviewed by management:

- total loans and commitments
- loans in excess of existing credit limits
- new extensions of credit, credit renewals, and restructured credits
- a listing of all delinquent and/or nonaccrual loans
- credits adversely graded or requiring special attention
- credits to insiders and their related interests
- credits not in compliance with bank policies as well as applicable statutes and regulations
- specific lending activity aspects, including automated financial statement spreads of borrowers and analyses of the bank's credit exposure by type, geographic areas, collateral, and large employers

CREDIT RISK REVIEW SYSTEMS

An effective credit risk review function is integral to the safe and sound operation of every insured depository institution. The internal credit risk review function should not be merely an after-the-fact, loan-by-loan review, but a process to detect weaknesses in the various levels of an institution's credit approval and monitoring system. This manual's section, "Credit Risk Review Systems," provides more information on practices and principles for developing and maintaining a credit risk review function consistent with safe and sound credit risk management practice. See also SR-20-13.

Examination Scope Guidance

An effective loan review function can greatly assist examiners in their review of the bank's loan portfolio. The examination process should evaluate the internal loan-review function by assessing the scope and depth of the review and the quality of the output. While examiners should not rely entirely on the bank's findings, they can limit the scope of their loan examination by developing a comfort level with the bank's internal loan-review function. To determine the reliability, if any, of the internal loan-review function, examiners should assess the adequacy of management's ability to identify problem loans. Two issues should be evaluated in this regard: timeliness and accuracy. The first issue deals with the ability of loan review to distinguish a problem loan and/or borrower from a nonproblem one when it initially becomes a problem. The second issue deals with the accuracy of loan review in identifying the severity of the problem. The Extent that examiners rely on an internal loan-review function depends upon their comfort level with the bank in the aforementioned regard.

The examiner will be able to determine the degree to which the bank's loan review function can be relied upon by reviewing prior examination criticisms, as well as management's response to them, and a sufficient sample of the bank's portfolio. Whether the borrower being reviewed as a part of the sampling process is a pass or nonpass credit, examiners should consider narrowing the scope of the pass credits included in the loan examination if they concur with the bank's risk ratings. However, examiners still should continue their analysis of all "nonpass" credits due to their importance to the adequacy of the ALLL.

NONACCRUAL LOANS

Loans and lease-financing receivables are to be placed on nonaccrual status if (1) principal or interest has been in default for 90 days or more, unless the loan is both well secured and in the process of collection; (2) payment in full of principal or interest is not expected; or (3) they are maintained on a cash basis because the financial condition of the borrower has deteriorated.

Definition of "well secured" and "in the process of collection"—An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or (2) in appropriate circumstances, through collection efforts not involving legal action, which are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future. For the purposes of applying the above third test for nonaccrual status, the date on which an asset reaches nonaccrual status is determined by its contractual terms that principal or interest has been in default for a period of 90 days or more, unless the asset is both well secured and in the process of collection. If the principal or interest on an asset becomes due and remains unpaid for 90 days or more on a date that falls between report dates, the asset should be placed in nonaccrual status as of the date it becomes 90 days past due. It should remain in nonaccrual status until it meets the following exception criteria for restoration to accrual status described below. (Any state statute, regulation, or rule that imposes more stringent standards for nonaccrual of interest should take precedence over this instruction.)

Exceptions—A loan does *not* need to be placed on nonaccrual status if (1) the criteria for accrual of income under the interest method specified in Accounting Standards Council (ASC) Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"), are met for a purchased impaired loan or debt security accounted for in accordance with that subtopic, regardless of whether the loan or debt security had been maintained in nonaccrual status by its seller; (2) the criteria for amortization specified in AICPA Practice Bulletin No. 6 are met with respect to a loan or other debt instrument accounted for in accordance with that Practice Bulletin that was acquired at a discount from an unaffiliated third party, including those that the seller has maintained on nonaccrual status; or (3) the loan is a consumer loan or secured by a one- to four-family residential property. However, the bank may elect to carry these loans on a nonaccrual status. Also, if a bank has a significant consumer or residential mortgage loan portfolio in relation to its total loans and tier 1 capital, a thorough review of the delinquency status should be performed to ensure that the bank has not materially misstated its financial condition and earnings.

Treatment of Cash Payments and Criteria for the Cash-Basis Treatment of Income—When a bank places a loan on nonaccrual status, it must consider how to account for subsequent payments. When the collectibility of the remaining book balance of a loan on nonaccrual status is uncertain, any payments received must be applied to reduce the recorded investment in the asset or principal to the extent necessary to eliminate such doubt. Placing an asset on nonaccrual status does not require a charge-off, in whole or in part, of the asset's principal. However, *any identified losses* must be charged off.

When a loan is on nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis, as long as the remaining recorded balance of the asset after the charge-off, if any, is deemed fully collectible.[8] A bank's determination of the collectibility of an asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and repayment prospects.

When recognition of interest income on a cash basis is appropriate, the amount of income recognized should be limited to what would have been accrued on the loan's remaining book balance at the contractual rate. Any cash interest payments received over this limit (and not applied to reduce the loan's remaining book balance) should be recorded as recoveries of prior charge-offs until these charge-offs have been fully recovered. (A bank should have a well-defined policy governing the treatment of interest income and the charge-off of accrued interest receivables.)

Treatment of Previously Accrued But Uncollected Interest—When a bank places a loan on nonaccrual status, its policy should address an appropriate treatment of previously accrued but uncollected interest. One method is to reverse all previously accrued but uncollected interest against appropriate income and balance-sheet accounts. For interest accrued in the current accounting period, the entry is made directly against the interest income account. For prior accounting periods, if accrued-interest provisions to the ALLL were not made, the amount of accrued but uncollected interest should be charged against current earnings. Also for prior accounting periods when provisions to the ALLL for possible loss of interest had been made, the bank generally reverses the accrued but uncollected interest by charging the ALLL to the extent of those specific provisions. Generally accepted accounting principles do not require the write-off of previously accrued interest if principal and interest are ultimately protected by sound collateral values. A bank is expected to have a well-defined policy, subject to examiner review, governing the write-off of accrued interest.

Treatment of Multiple Extensions of Credit to One Borrower—As a general rule, nonaccrual status for an asset should be determined by assessing its collectibility, repayment ability, and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a bank does not automatically have to place all of that borrower's other extensions of credit in nonaccrual status. The bank should evaluate its other extensions of credit to that borrower to determine if one or more of them also should be placed in nonaccrual status.

Restoration to Accrual Status—As a general rule, a nonaccrual loan may be restored to accrual status when (1) its principal and interest are no longer past due and unpaid, and the bank expects repayment of the remaining principal and interest, or (2) when it otherwise becomes well secured and in the process of collection. Before restoring a loan to accrual status, the bank should consider the borrower's prospects for continuing future contractual payments. If reasonable doubt exists, reinstatement may not be appropriate.

To meet the first test, the bank must have received payment of the past-due principal and interest, unless (1) the loan has been formally restructured and qualifies for accrual status under the restructured terms; (2) the asset is a purchased impaired loan or debt security accounted for in accordance with ASC Subtopic 310-30 and it meets the criteria for accrual of income under the interest method specified therein; or (3) the asset has been acquired at a discount (due to uncertainty about the amounts or timing of future cash flows) from an unaffiliated third party and meets the amortization criteria (that is, accretion of discount) specified in AICPA Practice Bulletin No. 6 or the borrower has resumed

8. An asset in nonaccrual status that is subject to the cost recovery method required by former AICPA Practice Bulletin No. 6 or ASC Subtopic 325-40, Investments–Other—Beneficial Interests in Securitized Financial Assets (formerly Emerging Issues Task Force Issue No. 99-20, "Recognition of Interest Income and Impairment on Purchased Beneficial Interests and Beneficial Interests That Continue to Be Held by a Transferor in Securitized Financial Assets"), should follow that method for reporting purposes. In addition, when a purchased impaired loan or debt security that is accounted for in accordance with ASC Subtopic 310-30 has been placed on nonaccrual status, the cost recovery method should be used, when appropriate.

paying contractual interest and principal payments on the loan, even if the past-due amount has not been brought fully current. These loans may be returned to accrual status provided two criteria are met: (1) all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within a reasonable period, and (2) the borrower has a sustained period of repayment performance (generally a minimum of six months) in accordance with the contractual terms.

Until the loan is restored to accrual status, cash payments received must be treated according to the criteria stated above. In addition, after a formal restructuring, if the loan that has been returned to accrual status later meets the criteria for placement in nonaccrual status (as a result of past-due status based on its modified terms or for any other reason), the asset must be placed on nonaccrual status.

Treatment of Nonaccrual Loans with Partial Charge-Offs—GAAP and regulatory reporting requirements do not explicitly address whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must be fully recovered before a loan can be restored to accrual status.

According to Call Report instructions, restoration to accrual status is permitted when (1) the loan has been brought fully current with respect to principal and interest and (2) the bank expects the loan's full contractual balance (including any amounts charged off), plus interest, will be fully collectible under the terms of the loan. Thus, to return a partially charged-off loan that has been brought fully current to accrual status, the bank should determine if it expects to receive the full amount of principal and interest called for by the loan's terms.

When the contractual principal and interest of a loan have been brought fully current, and the borrower's financial condition and repayment prospects have improved so that the full contractual principal (including any amounts charged off) and interest is expected to be repaid, the loan may be restored to accrual status *without* having to first recover the charge-off. Conversely, this treatment would be inappropriate when the charge-off indicates continuing doubt about the collectibility of principal or interest.

The reasons for restoring a partially charged-off loan to accrual status must be documented. These actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for full repayment of contractual principal (including any amounts charged off) and interest. This documentation will be subject to review by examiners.

Examiner Review—Some states have promulgated regulations or adopted policies for nonaccrual of interest on delinquent loans that may differ from the above procedures. In these cases, the bank should comply with the more restrictive policy. The examiner should ensure that the bank is complying with such guidelines. In all cases, each bank should formulate its own policies to ensure that net income is not being overstated. These policies are subject to examiner review.

RESTRUCTURED OR RENEGOTIATED "TROUBLED" DEBT

In a "troubled-debt restructuring," a bank grants a borrower concessions for economic or legal reasons related to a borrower's financial difficulties that it would not otherwise consider. Renegotiated "troubled" debt includes (1) the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan; (2) modification of loan terms, such as a reduction of the stated interest rate, principal, or accrued interest, or an extension of the maturity date for new debt with similar risk; or (3) a combination of the above. A loan extended or renewed at a stated rate equal to the current interest rate for new debt with similar risk is not considered renegotiated debt. For further information, see the instructions for the Reports of Condition and Income; and ASC Subtopic 310-40, Receivables—Troubled Debt Restructurings by Creditors (formerly FASB Statement No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings," as amended by FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan"). All loans whose terms have been modified in a troubled debt restructuring must be evaluated for impairment under ASC topic 310, "Receivables." Under ASC Topic 310, a measuring of impairment on a troubled loan using the present value of future cash flows should be discounted at the effective interest rate of the original loan (that is, before the restructuring).[9]

A bank should develop a policy for renegotiated troubled debt to ensure that such items are identified, monitored, and properly accounted for and controlled. These restructurings should occur infrequently. If not, the bank is probably experiencing significant problems. Before troubled-debt concessions are made to a borrower, it is a good practice to have the transactions receive prior approval of the board of directors or a board committee. All these transactions should be reported to the board of directors upon enactment.

Bankers may be involved in formally restructuring loans when borrowers experience financial difficulties or in light of the borrower's condition and repayment prospects.[10] These actions, if consistent with prudent lending principles and supervisory practices, can improve a bank's collection prospects. GAAP and regulatory reporting requirements provide a reporting framework that may alleviate some of the lender's concerns about working constructively with borrowers experiencing financial difficulties.

The interagency policy statement on credit availability, issued March 1, 1991, clarifies a number of supervisory policies on restructured-loan issues. Two of these clarifications indicate that when certain criteria are met, (1) nonaccrual assets can be restored to accrual status when subject to formal restructurings in accordance with ASC Subtopic 310-40 and (2) restructurings that yield a market rate of interest would not have to be included in restructured loan amounts reported in the years following the restructuring. These clarifications, which are consistent with GAAP, have been fully incorporated into the instructions for the Reports of Condition and Income (Call Reports).

Restructurings

A loan or other debt instrument that has been formally restructured to ensure repayment and performance need not be maintained in nonaccrual status. In deciding whether to return an asset to accruing status, payment performance that had been sustained for a reasonable time before the restructuring may be considered. For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. It may be that the amount and frequency of payments under the restructured terms do not exceed those of the payments that the borrower had made over a sustained period within a reasonable time before the restructuring. In this situation, if the lender is reasonably assured of repayment and performance according to the modified terms, the loan can be immediately restored to accrual status.

A period of sustained performance, whether before or after the date of the restructuring, is very important in determining whether there is reasonable assurance of repayment and performance. In certain circumstances, other information may be sufficient to demonstrate an improvement in the borrower's condition or in economic conditions that may affect the borrower's ability to repay. This information may reduce the need to rely on the borrower's performance to date in assessing repayment prospects. For example, if the borrower has obtained substantial and reliable sales, lease, or rental contracts or if other important developments are expected to significantly increase the borrower's cash flow and debt-service capacity and strength, then the borrower's commitment to repay may be sufficient. A preponderance of such evidence may be sufficient to warrant returning a restructured loan to accrual status. The restructured terms must reasonably ensure performance and full repayment.

It is imperative that the reasons for restoring restructured debt to accrual status be documented. A restoration should be supported by a current, well-documented evaluation of the bor-

9. FASB 118 amended FASB 114 to allow creditors to use existing methods for recognizing interest income on impaired loans. This statement also clarifies the existing accounting for in-substance foreclosure. Under the impairment standard and related amendments to FASB 15, a collateral-dependent real estate loan (that is, a loan for which repayment is expected to be provided solely by the underlying collateral) would be reported as OREO only if the lender has taken possession of the collateral. For other collateral-dependent real estate loans, loss recognition would be based on the fair value of the collateral if foreclosure is probable. However, these loans would no longer be reported as OREO. Rather, they would remain in the loan category. In light of the significance of these changes to accounting standards, the Federal Reserve is reevaluating regulatory disclosure and nonaccrual requirements and expects to issue revised policies at a later date. (See SR-93-30 (FIS).) FASB 15 is also amended by FASB statements 71, 111, 121, 141, 145, and 149. (See FASB's current text.)

10. For further guidance on loan restructuring and workout arrangements, refer to the Statement on Working with Mortgage Borrowers that was issued by the Federal Reserve and the other federal financial institution regulatory agencies (see SR-07-6).

rower's financial condition and prospects for repayment. This documentation will be reviewed by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that will improve the likelihood that the credit will be repaid in full in accordance with reasonably restructured repayment terms. A restructured loan may not be restored to accrual status unless there is reasonable assurance of repayment and performance under its modified terms in accordance with a reasonable repayment schedule. Regulatory reporting requirements and GAAP do *not* require a banking organization that restructures a loan to grant excessive concessions, forgive principle, or take other steps not commensurate with the borrower's ability to repay to use the reporting treatment specified in ASC Subtopic 310-40 (formerly FASB Statement No. 15). Furthermore, the restructured terms may include prudent contingent payment provisions that permit an institution to obtain appropriate recovery of concessions granted in the restructuring, if the borrower's condition substantially improves.

Moreover, while restructured debt that qualifies for accrual status and yields a market rate of interest must be disclosed as a troubled debt in the year of the restructuring, it need not be disclosed in subsequent years.

Reporting Guidance on Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in ASC Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs (formerly FASB Statement No. 91, "Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Cost of Leases"). In general, this statement says loan-origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield. The statement applies to all types of loans, as well as to debt securities (but not to loans or securities carried at fair value if the changes in fair value are included in earnings), and to all types of lenders. For further information, see the instructions for preparing the Call Report.

PROBLEM ASSET DISPOSAL THROUGH EXCHANGES

Financial institutions explore strategies to dispose of or reduce nonperforming assets and other real estate owned (OREO). Some of these strategies include so-called "asset exchanges," whereby third parties or marketing agents have offered to purchase problem assets from institutions and replace them with performing assets. Such transactions, if properly executed with reputable counterparties and when they are subjected to the appropriate level of due diligence, may achieve the objective of reducing nonperforming assets on financial institutions' balance sheets. Other less structured transactions may present significant risk to institutions and could compromise their safety and soundness.

The guidance in this section highlights the potential risks associated specifically with transactions which may reduce problem assets in the short term, but where a lack of appropriate, up-front due diligence may result in heightened risks over the longer term. In addition, inappropriate assumptions used in determining the fair value of the purchased assets may result in institutions being required to recognize losses shortly after inception of the transaction.

Third parties or marketing agents may offer to purchase problem assets from institutions and replace them with performing assets to help institutions diversify their loan portfolios. Institutions may perceive that asset exchange transactions offer the potential to increase interest income, reduce the level of real estate concentrations, enhance liquidity, and reduce the stress on capital. Nevertheless, these transactions may pose significant risks. Sellers could be exchanging problem assets for purportedly performing assets (acquired assets) that were recorded at values in excess of fair value. See SR-11-15.

Risk-Management Considerations

Asset exchanges may expose institutions to significant risks, which management should assess before entering into such transactions. Management should focus not only on the immediate or short-term benefits of a transaction, but should determine its long-term effect on the institution's balance sheet and loss exposure. Management should also determine how these risks align with the institution's overall risk-management strategy.

In undertaking due diligence on these types of transactions, management should assess the risks and provide evidence of its analysis, taking into account—

- the reported benefits to the institution from the transfer. This assessment should address whether the transaction would actually enable the institution to transfer significant risk associated with the problem assets.
- the economic costs and benefits of the transaction. This should include the economic benefits accruing to the marketing agent; the marketing agent's responsibilities and liabilities; and the loss position, including recourse, of each participant if either the ceded assets or acquired assets do not perform as anticipated.
- the servicing responsibilities attached to the acquired assets. If the institution assumes servicing responsibilities for the acquired assets, the institution should evaluate and show evidence that it has the capacity and infrastructure in place, as well as appropriate risk controls, to service the acquired assets.
- the transaction's compliance with the risk-tolerance and risk-mitigation policies established by the institution's board of directors, including the overall strategy for managing or reducing problem assets.
- the appropriate accounting treatment in accordance with U.S. generally accepted accounting principles (GAAP). Specific issues with regard to the appropriate accounting treatment include, but are not limited to, the following:
  - — When specific loans are identified for inclusion in exchange transactions and the institution decides to sell the loans, they should be transferred to a "held-for-sale" account at the lower of cost or fair value with losses recognized through earnings. Any reduction in value should be reflected as a write-down of the recorded investment resulting in a new cost basis. The sale of these loans should occur at an appropriate fair value.
  - — Newly acquired assets should be recorded at an appropriate fair value.
- a review of the marketing agent. This should include, but not be limited to, an assessment of the agent's financial strength, including its ability to provide credit enhancement if it is required in the transaction.
- the relationship between the marketing agent and any entity providing services for the transaction, with particular attention paid to possible cross-ownership or other related-party relationships.
- an independent valuation by a reputable and experienced third-party valuation expert of the assets being acquired. The party that performs the valuation should be independent of the marketing agent and the institution selling the performing assets. The use of outside resources does not relieve management of its responsibility to ensure that fair-value estimates are measured in accordance with GAAP.[11] Management should sufficiently understand the bases for the measurement and valuation techniques used by outside parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair-value measurements.[12]
- the acquiring institution's experience, skills, personnel, and risk-management capabilities to manage the newly acquired assets, especially if the assets are in business segments or geographical areas that are different from the institution's own.

Supervisory Responsibilities

It is not necessary to scope a specific review of these transactions into routine examination activities, particularly when there is no evidence that a bank has engaged in such transactions. Reserve Banks nevertheless should be aware of indications of possible asset exchange transactions as part of their routine monitoring of financial institutions between examinations. Examiners should hold ongoing discussions with an institution's management as part of the supervision process if examiners become aware that the institution is considering these types of transactions. Monitoring activities should focus on financial statement changes commonly associated with asset exchanges, internal risk-management reports, and other documents received on a routine basis. Indicators that asset

11. Fair-value measurements are determined based on assumptions that market participants would use in valuing the assets. This should include a risk premium reflecting the amount market participants would demand because of the risk (uncertainty) in the cash flows.

12. Examples of significant inputs and assumptions include, but are not limited to, default probabilities, current loan-to-value ratios, loss severities, and prepayment speeds.

exchanges might have taken place include—

- asset sales at (or very near) book values, with either no loss recognized or a gain on recovery of a prior write-down recognized. It is unusual for a third party to buy problem assets at higher than the selling institution's book value at the time of the sale.
- board minutes showing discussion of strategies designed to achieve material reductions in problem assets.
- material loan sales and purchases involving the same counterparty, on or around the same date.
- significant reductions in the institution's nonperforming loan totals without attendant losses. The motivation for asset exchanges is to reduce problem assets, but this may be difficult to do in the current economic environment without realizing significant losses.
- purchase of a large portfolio of loans that are outside the institution's traditional markets and/or are inconsistent with the institution's business strategies or lending and investment policies.
- purchase at (or near) par of a large portfolio of loans that, while currently performing, have high-risk characteristics (e.g., are outside generally accepted underwriting standards for this type of credit) that indicate they may not continue to perform in accordance with their contractual terms.
- large net loan or asset growth during a short period. Because asset exchanges nearly always involve an institution purchasing more assets than it is selling, it is common for the balance sheet to grow rapidly as a result of the asset exchange transaction.

Supervisory Actions

If examiners observe an institution engaging in asset exchanges, they should determine whether the appropriate risk-management measures have been considered and if management has used appropriate valuations in accordance with GAAP. Important findings should be noted in the examination report and, as appropriate, plans for remedial action discussed with management. Given the concern regarding both safety-and-soundness issues as well as the appropriate valuation practices, Reserve Banks should contact the appropriate Board staff analyst to discuss the asset exchange transaction.

TRANSFER OF LOW-QUALITY LOANS OR OTHER ASSETS

Section 23A of the Federal Reserve Act (FRA), 12 U.S.C. 371c, prohibits bank purchases of low-quality assets from an affiliate. In addition to the statutory provisions of section 23A, the Board approved the issuance of Regulation W, which became effective April 1, 2003, implementing changes to sections 23A and 23B of the FRA.

Low-quality loans include those classified or specially mentioned at the most recent examination or loans that would most likely be classified or specially mentioned if subjected to a review. In addition, low-quality loans include 30-day past-due loans, nonaccrual loans, loans on which the terms have been renegotiated because of a borrower's poor financial condition, and any other loans the examiner believes are questionable. Other assets of questionable quality include depreciated or subinvestment-grade securities and other real estate. A low-quality asset shall not be acceptable as collateral for a loan or extension of credit to, or guarantee, acceptance, or letter of credit issued on behalf of an affiliate. Furthermore, a low-quality asset cannot be involved in a loan participation or an asset swap.

The transfer of low-quality loans or other assets from one depository institution to another may raise supervisory concerns. These transfers may be made to avoid detection and classification during regulatory examinations and may be accomplished through participation, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Examiners should be alert to situations in which an institution's intention appears to be concealing low-quality assets to avoid examiners' scrutiny and possible classification.

During bank examinations, examiners are requested to identify situations when low-quality assets have been transferred between the institution being examined and another depository institution. The transfer of assets to avoid supervisory review is a highly improper and unsound banking practice and, if an affiliate is involved, is a violation of section 23A of the Federal Reserve Act. If necessary, it should be addressed through formal supervisory enforcement action.

Any transfers of low-quality or questionable assets should be brought to the attention of

Reserve Bank supervisory personnel. In turn, these individuals should notify the local offices of primary federal and state regulators (if applicable) of the other depository institutions involved in the transaction. For example, Reserve Banks should notify the primary federal and state regulators (if applicable) of any depository institution to which a state member bank or holding company is transferring or has transferred low-quality loans. Reserve Banks should also notify the primary federal and state regulators (if applicable) of any depository institution from which a state member bank or holding company is acquiring or has acquired low-quality loans. This procedure applies to transfers involving savings and loan associations, savings banks, and commercial banking organizations.

If the examiner determines a permissible transfer of assets was undertaken, he or she should ensure the assets have been properly recorded at fair market value on the books of the acquiring institution. If the transfer involved the parent holding company or a nonbank affiliate, the examiner should determine if the transaction also was recorded properly on the affiliate's books.[13]

Whenever asset transfers occur, examiners should determine whether the assets in question were independently and completely evaluated for conformance with bank policy and procedures. Examiners should be guided by the inspection procedures outlined in section 2020.7.2 of the *Bank Holding Company Supervision Manual* and the examination procedures in section 6070.3 of this manual.

ENVIRONMENTAL LIABILITY

Banks may be liable for cleaning up hazardous substance contamination under both federal and state environmental liability statutes. This liability can arise through a bank's ownership or acquisition of real estate, in its role as a creditor, or in a fiduciary role. Banks may also be exposed to environmental liability indirectly through the increased possibility that a borrower's creditworthiness may be impaired by a liability to pay for cleanup of contaminated property, even if the property does not secure bank debt.

The Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the federal superfund statute, authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the cleanup from entities specified in the statute. While the superfund statute is the primary federal law dealing with hazardous substance contamination, numerous other federal and state statutes establish environmental liability that could place banks at risk.

CERCLA defines who is subject to liability for the costs of cleaning up hazardous substance contamination. The definition includes ". . . the owner and operator of a vessel or a facility, (or) any person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of. . . ."[14] Under the statute, a person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination.

The superfund statute imposes a standard of strict liability, which means the government does not have to prove that the owners or operators knew about or caused the hazardous substance contamination in order for them to be liable for the cleanup costs. Moreover, liability under the statute is joint and several, which allows the government to seek recovery of the entire cost from any individual party that is liable for those costs under CERCLA.

CERCLA provides an exemption for secured creditors in the definition of "owner and operator" by stating that these terms do not include ". . . a person, who, without participating in the management of a vessel or facility, holds indicia of ownership primarily to protect his security interest in the vessel or facility."[15] However, this exception has not provided banks with an effective defense from liability because courts have limited its applicability. Specifically, courts have held that some lenders' actions to protect their security interests have resulted in the bank "participating in the management of a vessel or facility," thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the bank, some courts have held that the exemption no longer applies and that the bank is liable under the superfund statute as an "owner" of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without knowing about existing conditions (the "innocent landowner

13. See section 6070.1 of this manual.

14. CERCLA, section 107(a).

15. CERCLA, section 101(20)(A).

defense"). However, the courts have applied a stringent standard to qualify for this defense. Since the statute provides little guidance as to what constitutes the appropriate timing and degree of due diligence to successfully employ this exemption, banks should exercise caution before relying on it.

Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals as ingredients or waste products. For years, these types of hazardous substances were frequently disposed of in landfills or dumped on industrial sites. However, hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of hazardous substances, but by no means cover them all:

- farmers and ranchers (fuel, fertilizers, herbicides, insecticides, and feedlot runoff)
- dry cleaners (various cleaning solvents)
- service station and convenience store operators (underground storage tanks)
- fertilizer and chemical dealers and applicators (storage and transportation of chemicals)
- lawn care businesses (application of lawn chemicals)
- trucking firms (transportation of substances such as fuel or chemicals)

Environmental liability has had the greatest impact on the real estate industry. Not only has land itself been contaminated with toxic substances, construction methods for projects such as commercial buildings have used materials that have been subsequently determined to be hazardous—resulting in significant declines in project values. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos has since been found to be a health hazard and now, in many cases, must be removed or its effects abated by enclosing or otherwise sealing off the contaminated areas.

Another common source of hazardous substance contamination is underground storage tanks. Leaks from these tanks not only contaminate the surrounding ground, but often flow into ground water and travel a significant distance from the original contamination site. As contamination spreads to other sites, cleanup costs escalate.

Effect on Banks—A bank may encounter losses from environmental liability through direct ownership, lending and trust activities, or mergers or acquisitions of borrowers. The greatest risk to a bank is the possibility of being held solely liable for costly environmental cleanups. Under the doctrine of joint and several liability, a bank may find itself solely responsible for cleaning up a contaminated site at a cost that exceeds any outstanding loan balance or property value.

Direct Ownership

A bank may be held liable for the cleanup of hazardous substance contamination in situations when it—

- takes title to property through foreclosure or acquires property to satisfy debts previously contracted;
- owns or acquires for future expansion premises that have been contaminated by hazardous substances; or
- owns, acquires, or merges with another entity involved in activities that might result in a finding of environmental liability.

Lending Activity—While real estate loans present the greatest risk, almost any type of loan, unsecured or secured, can expose a bank to the effects of environmental liability. A borrower who is required to pay for the cleanup of a contaminated property may be unable to provide the necessary funds both to remove contaminated materials and to service the debt. Even if the bank does not have a security interest in the borrower's real estate, it must be aware that significant cleanup costs could threaten the borrower's solvency and net worth (and jeopardize the collection of working-capital or equipment loans). If the loan is secured by the contaminated real estate, the bank may find that the property value has declined dramatically, depending on the degree of contamination. In determining whether to foreclose, the bank must compare the estimated cleanup costs against the value of the collateral. In many cases, this estimated cost has been well in excess of the outstanding loan balance, and the bank has elected to abandon its security interest in the property and charge off the loan. This situation occurs because some courts have not allowed banks that have foreclosed on a property to avail themselves of the secured-creditor exemption. These rulings have been based on a strict reading of the superfund statute that provides the exemption to "security interests" only.

A bank may also expose itself to environmental liability in its role as a secured or unsecured creditor if it involves bank personnel or contractors engaged by the bank in day-to-day management of the facility or takes actions designed to make the contaminated property salable, possibly resulting in further contamination.

Bank Premises—Banks may also be exposed to environmental liability for property held as bank premises. A review of historical uses of properties to be acquired for relocation or future expansion should provide insight into the likelihood that contamination may have occurred and whether additional steps may be warranted.

Mergers and Acquisitions of Borrowers—Borrowers may face environmental risk through the activities of subsidiaries or by merging with or acquiring other companies whose activities result in environmental liability. Some courts have held that for the purposes of determining liability under the superfund statute, the corporate veil may not protect parent companies that participate in the day-to-day operations of their subsidiaries from environmental liability and court-imposed cleanup costs. Additionally, borrowers and, ultimately, banks can be held liable for contamination that occurred before they owned or used the real estate.

Protection Against Environmental Liability

Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability. The following discussion briefly describes methods that banks may employ to minimize potential environmental liability.

Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests. The loan policy should describe an appropriate degree of due diligence investigation required for credit requests. Borrowers in high-risk industries or localities should be investigated more stringently than borrowers in low-risk industries or localities.

After a loan is granted, periodic credit analysis of the borrower's ability to repay should include an assessment of environmental risk. If the credit is secured by real property collateral, the bank should remain aware of the property's uses and the potential environmental risk associated with those uses. Even if the credit is not secured by real property, periodic credit reviews should determine whether repayment prospects may be jeopardized by any activities that might expose the borrower to environmental liability.

The first step in identifying environmental risk is an environmental review. These reviews may be performed by loan officers or others. They typically identify past uses of the property; evaluate regulatory compliance, if applicable; and identify potential problems. The reviewer should interview persons familiar with present and past uses of the facility and property, review relevant records and documents, and inspect the site.

When the environmental review reveals possible hazardous substance contamination, an environmental assessment or audit may be required. Environmental assessments are made by personnel trained in identifying potential environmental hazards and provide a more thorough inspection of the facility and property. Environmental audits differ markedly from environmental assessments because independent environmental engineers are employed to investigate the property in great detail. Engineers test for hazardous substance contamination, which might require collecting and analyzing air samples, surface soil samples, or subsurface soil samples or drilling wells to sample ground water.

Other measures some banks use to help identify and minimize environmental liability to the bank include obtaining indemnities from borrowers for any cleanup costs incurred by the bank and writing affirmative covenants into loan agreements (and attendant default provisions) that require the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, their effectiveness depends on the financial strength of the borrower and does not represent a substitute for environmental reviews, assessments, and audits.

Banks must be careful that any policies and procedures undertaken to assess and control environmental liability cannot be construed as taking an active role in the management or day-to-day operations of the borrower's business. Some activities that courts could consider active participation in the management of the borrower's business and that could subject the bank to potential liability include—

- having bank employees serve as members of the borrower's board of directors or actively participate in board decisions,
- assisting in day-to-day management and operating decisions, and
- actively determining management changes.

These considerations are especially important when the bank is actively involved in loan workouts or debt restructuring.

LOAN PROBLEMS

The failure of directors to establish a sound lending policy, require management to establish adequate written procedures, and monitor and administer the lending function within established guidelines has resulted in substantial problems for many institutions. Loan problems may be caused by a number of factors affecting the bank or its borrowers. For a discussion of the indicators of troubled commercial real estate loans, see the real estate loan sections of this manual. The major sources and causes of problem credits are explained below.

Competition—Competition among banks for size and community influence may result in compromising credit principles and making or acquiring unsound loans. The ultimate cost of unsound loans always outweighs temporary gains in growth and influence.

Complacency—The following items manifest complacency and should always be guarded against:

- lack of adequate supervision of long-term and familiar borrowers
- dependence on oral information the borrower furnished in lieu of reliable and verifiable financial data
- optimistic interpretation of known credit weaknesses based on past survival of recurrent hazards and distress
- ignorance or disregard of warning signs about the borrower, economy, region, industry, or other related factors

Compromise of credit principles. For various reasons, bank management may grant loans carrying undue risks or unsatisfactory terms, with full knowledge of the violation of sound credit principles. The reasons management may compromise basic credit principles include timidity in dealing with individuals with dominating personalities or influential connections, friendships, or personal conflicts of interest. Self-dealing, salary incentives, and bonuses based on loan portfolio growth, as well as competitive pressures, may also lead to a compromise of credit principles.

Failure to obtain or enforce repayment agreements. Loans granted without a clear repayment agreement are, at the very least, a departure from fundamental banking principles. These loans are likely to become significant problems. A more common problem, but just as undesirable, occurs when the bank and borrower agree on repayment or progressive liquidation of a loan, but the bank fails to collect the principal payments when and how it should. A study of loan losses will show that, in many cases, amortization never equaled the principal payments the borrower agreed to make. Good lending and good borrowing both require consistent liquidation.

Incomplete credit information. Complete credit information is necessary to make a reasonable and accurate determination of a borrower's financial condition and repayment capacity. Adequate and comparative financial statements, operating statements, and other pertinent statistical data should be available. Other essential information, such as the purpose of the borrowing and the intended plan and repayment source, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the bank's credit files. The lack of adequate credit information can limit management's ability to react quickly and effectively when problems develop.

Lack of supervision. Many loans that are sound at their inception develop into problems and losses because of ineffective supervision. This lack of supervision usually results from a lack of knowledge about the borrower's affairs over the lifetime of the loan.

Overlending. In one sense, overlending could come under the heading of technical incompetence. However, overlending is a weakness found in some lenders that are otherwise competent. Loans beyond the borrower's reasonable capacity to repay are unsound. Nowhere are technical competence and credit judgment more important than in determining a sound borrower's safe, maximum loan level.

Poor selection of risks. When banks are willing to assume more-than-normal risk levels, they often experience serious loan problems. The following general loan types may fall within the category of poor risk selection:

- loans in which the bank advances an excessive proportion of the required capital relative to the borrower's equity investment
- loans based more on the expectation of successfully completing a business transaction than on the existing net worth and repayment capacity
- loans for the speculative purchase of securities or goods
- loans collateralized by marketable assets carried without adequate margins of security
- loans made for other benefits, such as control of large deposit balances in the bank, instead of sound net worth, collateral, or repayment capacity
- loans secured solely by the nonmarketable stock of a local corporation, made in conjunction with loans directly to that corporation (The bank may consider itself forced to finance the corporation far beyond warranted limits to avoid loss on a loan that relies on the corporation's stock.)
- loans predicated on collateral of uncertain liquidation value (A moderate amount of these loans, when recognized by bank management as subject to inherent weakness, may cause few problems. However, the bank can encounter trouble if this practice becomes the rule.)

Revenue-driven lending. The loan portfolio is usually a bank's most important revenue-producing asset. The earnings factor, however, must never compromise sound credit judgment and allow credits carrying undue risks or unsatisfactory repayment terms to be granted. Unsound loans usually cost far more than the revenue they produce.

Self-Dealing. Self-dealing is found in many serious problem banks. Self-dealing often takes the form of an overextension of credit on an unsound basis to directors or principal shareholders, or to their related interests, who have improperly used their positions to obtain funds in the form of unjustified loans (or sometimes as fees, salaries, or payments for goods or services). Officers, who hold their positions at the pleasure of the board, may be pressured to approve loan requests by insiders that, coming from customers, would have been rejected. In that situation, management may attempt to defend unsound loans or other self-dealing practices by bank insiders.

Technical incompetence. All able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. When this ability is absent, unwarranted losses are certain to develop. Credit incompetence of management should be discussed promptly with the board of directors.

INSIDER LENDING

The Federal Reserve Board's Regulation O (12 CFR 215) implements many of the laws pertaining to extensions of credit by banks to their insiders. Regulation O was issued pursuant to sections 22(g) and 22(h) of the Federal Reserve Act. Regulation O is designed to mitigate the potential for conflicts of interest and self-dealing by individuals who may be in a position to influence a bank's lending decisions. For more information, see this manual's section, "Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks."

EXAMINATION OF THE LENDING FUNCTION

Banks are expected to clearly delineate their lending objectives, policies, and procedures in writing. Lending practices are then expected to adhere to policies and procedures, with exceptions properly justified and documented. The complexity and scope of a bank's lending policy and procedures should be appropriate to the bank's size and the nature of its activities, and they should be consistent with prudent banking practices and relevant regulatory requirements.

Historically, examiners have primarily identified loan-portfolio-management concerns through a detailed review of credits and credit documentation. This approach remains valid, but it must be combined with a full evaluation of a bank's lending objectives, policy, and procedures. Therefore, the scope of each examination should encompass a review of the bank's lending policy and procedures and an assessment of how lending practices adhere to the policy and procedures.

When conducting a review of loan portfolio management, examiners should pay particular attention to management's approach to and handling of the following:

- monitoring of lending practices by individual lending officers
- identification of concentrations of credit
- documentation of credit and collateral exceptions
- identification of problem credits
- accounting for nonaccrual loans and for renegotiated and restructured loans
- collection of past-due loans

In addition, examiners should be aware of any evidence of self-dealing in lending transactions.

An examiner's final assessment of a bank's lending function should consider the adequacy of internal policy and procedures, the effectiveness of management oversight and control, and the overall quality of the loan portfolio. Moreover, consideration should be given to all pertinent internal and external factors, including the continuity of management; bank's historical lending experience; and current and projected economic condition for the bank's market area, particularly for any industries in which the bank has concentrations of credit.

Supervisors and examiners should watch for indications of insufficiently rigorous risk assessment. In particular, examiners should be alert to circumstances indicating excessive reliance on strong economic conditions and robust financial markets, such as (1) borrowers whose financial capacity is inadequate to service their debts or (2) inadequate stress testing. Examiners also should be attentive when reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead the institution to delay recognition of emerging weaknesses in some loans.[16]

If examiners observe significant and undue reliance on favorable assumptions about borrowers or the economy and about financial markets more generally—or observe that this reliance has slowed the institution's recognition of loan problems—they should carefully consider downgrading, under the applicable supervisory rating framework, an institution's risk-management, management, or asset-quality ratings (or all three). If those assumptions are deemed sufficiently significant to the institution, examiners should also consider downgrading its capital adequacy rating. Similarly, if supervisors or examiners find that loan-review activities or other internal-control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, or inadequate training, such findings should be considered in supervisory ratings as well.

When developing their findings, examiners should review internal risk-management loan-review systems, conduct sufficient loan reviews, and perform transaction testing of the lending function to determine accurately the quality of bank loan portfolios and other credit exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the pre-examination risk assessment or of performing the examination, sufficient supervisory resources should be committed to in-depth reviews, including transaction testing. Adequate, in-depth reviews and transaction testing should be performed to ensure that the Reserve Bank achieves a full understanding of the nature, scope, and implications of the deficiencies.

Important findings should be noted in the examination or report. Plans for remedial actions should be discussed with bank management and the boards of directors, as appropriate. In addition, any identified weaknesses or deficiencies that could adversely affect affiliated insured depository institutions should be conveyed to the insured institution's primary federal or state supervisor.

16. Examiners should recognize that an increase in classified or special-mention loans is not per se an indication of lax lending standards. Examiners should review and consider the nature of such increases and surrounding circumstances as they reach their conclusions about the asset quality and risk management of an institution.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED modules for examination procedures:

- Loan Portfolio Review
- Loan Operations Review

An effective credit risk review function is integral to the safe and sound operation of every insured depository institution. In May 2020, the Office of the Comptroller of the Currency, the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the agencies) issued guidance for credit risk review. See 85 *Federal Register* 33,278 (June 1, 2020) and SR-20-13, "Interagency Guidance on Credit Risk Review Systems." To assist institutions in the creation and operation of such functions, the guidance for credit risk review describes a broad set of practices and principles for developing and maintaining a credit risk review function consistent with safe and sound credit risk-management practices and the *Interagency Guidelines Establishing Standards for Safety and Soundness* (safety and soundness guidelines).[1] However, the guidance for credit risk review does not establish any requirements or rules, nor does it mandate implementation of a specific system or prescribe specific actions with which institutions must comply.

The guidance discusses sound management of credit risk, a system of independent, ongoing credit review, and appropriate communication regarding the performance of the institution's loan portfolio to its management and board of directors. This guidance for credit risk review is relevant to all institutions supervised by the agencies and replaces attachment 1 of the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses. The nature of credit risk review systems typically varies based on an institution's size, complexity, loan types, risk profile, and risk-management practices. The remainder of this section conveys the Interagency Guidance on Credit Risk Review Systems with the exception of some references that were removed because they do not pertain to institutions for which the Federal Reserve is the primary regulator.

1. For state member banks, see 12 CFR part 208, appendix D-1.

INTERAGENCY GUIDANCE ON CREDIT RISK REVIEW SYSTEMS

Introduction

The safety and soundness guidelines underscore the critical importance of credit risk review and set safety and soundness standards for insured depository institutions to establish a system for independent, ongoing credit risk review, and for appropriate communication to their management and boards of directors.[2] The credit review guidance, which aligns with the safety and soundness guidelines, is appropriate for all institutions and describes a broad set of practices that can be used either within a dedicated unit or across multiple units throughout an institution to form a credit risk review system that is consistent with safe and sound lending practices.[3] This manual section presents guidance which outlines principles that an institution should consider in developing and maintaining an effective credit risk review system.

Overview of Credit Risk Review Systems

The nature of credit risk review systems varies based on an institution's size, complexity, loan types, risk profile, and risk-management practices.[4] For example, in smaller or less complex

2. For foreign banking organization branches, agencies, or subsidiaries not operating under single governance in the United States, the U.S. risk committee would serve in the role of the board of directors for purposes of this guidance.

3. For purposes of this guidance, regulated institutions are those supervised by the following agencies: The Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC).

4. The credit risk review function is not intended to be performed by an institution's internal audit function. However, as discussed in the agencies' March 2003 *Interagency Policy Statement on the Internal Audit Function and its Outsourcing* (2003 policy statement), some institutions coordinate the internal audit function with several risk monitoring functions, such as the credit risk review function. The 2003 policy statement states that coordination of credit risk review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the

institutions, a credit risk review system may include qualified members of the staff, including loan officers, other officers, or directors, who are independent of the credits being assessed. In larger or more complex institutions, a credit risk review system may include components of a dedicated credit risk review function that are independent of the institution's lending function.[5] A credit risk review system may also include various responsibilities assigned to credit underwriting, loan administration, a problem loan workout group, or other organizational units of an institution. Among other responsibilities, these groups may administer the internal problem loan reporting process, maintain the integrity of the credit risk rating process, confirm that timely and appropriate changes are made to risk ratings, and support the quality of information used to estimate the allowance for credit losses (ACL) or the allowance for loan and lease losses (ALLL), as applicable. Additionally, some or all of the credit risk review function may be performed by a qualified third party.

Regardless of the structure, an effective credit risk review system accomplishes the following objectives:

- Promptly identifies loans with actual and potential credit weaknesses so that timely action can be taken to strengthen credit quality and minimize losses.
- Appropriately validates and, if necessary, adjusts risk ratings, especially for those loans with potential or well-defined credit weaknesses that may jeopardize repayment.
- Identifies relevant trends that affect the quality of the loan portfolio and highlights segments of those portfolios that are potential problem areas.
- Assesses the adequacy of and adherence to internal credit policies and loan administration procedures and monitors compliance with applicable laws and regulations.
- Evaluates the activities of lending personnel and management, including compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- Provides management and the board of directors with an objective, independent, and timely assessment of the overall quality of the loan portfolio.
- Provides management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ACL or ALLL, as applicable.

Credit Risk Rating (or Grading) Framework

The foundation for any effective credit risk review system is accurate and timely risk ratings to assess credit quality and identify or confirm problem loans. An effective credit risk rating framework includes the monitoring of individual loans and retail credit portfolios, or segments thereof, with similar risk characteristics. An effective framework also provides important information on the collectability of each portfolio for use in the determination of an appropriate ACL or ALLL, as applicable. Further, an effective framework generally places primary reliance on the lending staff to assign accurate and timely risk ratings and identify emerging loan problems. However, given the importance of the credit risk rating framework, the lending personnel's assignment of risk ratings is typically subject to review by qualified and independent: (1) peers, managers, or loan committee(s); (2) part-time or full-time employee(s); (3) internal departments staffed with credit review specialists; or (4) external credit review consultants. A risk rating review that is independent of the lending function and approval pro-

institution's ability to comprehensively manage risk. However, an effective internal audit function maintains the ability to independently audit the credit risk review function. (The NCUA was not an issuing agency of the 2003 policy statement.)

5. Credit risk review may be referred to as loan review, credit review, asset quality review, or another name as chosen by an institution. The role of, expectations for, and scope of credit risk review as discussed in this guidance are distinct from the roles, expectations, and scope of work performed by other groups within an institution that are also responsible for monitoring, managing, and reporting credit risk. Examples may be those involved with lending functions, independent risk management, loan work outs, and accounting. Each institution indicates in its own policies and procedures the specific roles and responsibilities of these different groups, including separation of duties. A credit risk review unit, or individuals serving in that role, can rely on information provided by other units in developing its own independent assessment of credit risk in loan portfolios, but the credit risk review unit critically evaluates such information to maintain its own view, as opposed to relying exclusively on such information.

cess can provide a more objective assessment of credit quality.[6]

An effective credit risk rating framework includes the following attributes:

- a formal credit risk rating system in which the ratings reflect the risk of default and credit losses, and for which a written description of the credit risk framework is maintained, including a discussion of the factors used to assign appropriate risk ratings to individual loans and retail credit portfolios, or segments thereof, with similar risk characteristics;[7]
- identification or grouping of loans that warrant the special attention of management or other designated "watch lists" of loans that management is more closely monitoring;[8]
- clear explanation of why particular loans warrant the special attention of management or have received an adverse risk rating;
- evaluation of the effectiveness of approved workout plans;
- a method for communicating direct, periodic, and timely information to the institution's senior management and the board of directors or appropriate board committee on the status of loans identified as warranting special attention or adverse classification, and the actions taken by management to strengthen the credit quality of those loans; and
- evaluation of the institution's historical loss experience for each of the groups of loans with similar risk characteristics into which it has segmented its loan portfolio.[9]

Elements of an Effective Credit Risk Review System

An effective credit risk review system starts with a written credit risk review policy that is reviewed and typically approved at least annually by the institution's board of directors or appropriate board committee to evidence its support of, and commitment to, maintaining an effective system.[10] Effective policies include a description of the overall risk rating framework and establish responsibilities for loan review based on the portfolio being assessed. An effective credit risk review policy addresses the following elements, described in more detail below: the qualifications and independence of credit risk review personnel; the frequency, scope, and depth of reviews; the review of findings and follow-up; and communication and distribution of results.

Qualifications of Credit Risk Review Personnel

An effective credit risk review function is staffed with personnel who are qualified based on their level of education, experience, and extent of formal credit training. Qualified personnel are knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. The level of experience and expertise for all personnel involved in the credit risk review process is expected to be commensurate with the nature of the risk and complexity of the portfolios. In addition, qualified credit risk review personnel possess knowledge of relevant laws, regulations, and supervisory guidance.

6. Small or rural institutions that have few resources or employees may adopt modified credit risk review procedures and methods to achieve a proper degree of independence. For example, in the review process, such an institution may use qualified members of the staff, including loan officers, other officers, or directors, who are not involved with originating or approving the specific credits being assessed and whose compensation is not influenced by the assigned risk ratings. It is appropriate to employ such modified procedures when more robust procedures and methods are impractical. Institution management and the board, or a board committee, should have reasonable confidence that the personnel chosen will be able to conduct reviews with the needed independence despite their position within the loan function.

7. A bank or savings association may have a credit risk rating framework that differs from the framework for loan classifications used by the federal banking agencies. Such banks and savings associations should maintain documentation that translates their risk ratings into the regulatory classification framework used by the federal banking agencies. This documentation will enable examiners to reconcile the totals for the various loan classifications or risk ratings under the institution's system to the federal banking agencies' categories contained in the Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions Attachment 1 - Classification Definitions (SR-13-18).

8. In addition to loans designated as "watch list," this identification typically includes loans rated special mention, substandard, doubtful, or loss.

9. In particular, institutions with large and complex loan portfolios typically maintain records of their historical loss experience for credits in each of the categories in their risk rating framework. For banks and savings associations, these categories are either those used by, or those that can be translated into those used by, the federal banking agencies.

10. See 12 CFR part 208, appendix D-1 (Board).

Independence of Credit Risk Review Personnel

An effective credit risk review system incorporates both the initial identification of emerging problem loans by loan officers and other line staff, and an assessment of loans by personnel independent of the credit approval process. Placing primary responsibility on loan officers, risk officers, and line staff is important for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of frequent contact with borrowers, loan officers and line staff can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over-reliance on loan officers and line staff for identification of problem loans. An independent assessment of risk is achieved when personnel who perform the loan review do not have control over the loan and are not part of or influenced by individuals associated with the loan approval process.

While a larger institution may establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in a smaller institution. For example, in the review process, smaller institutions may use an independent committee of outside directors or qualified members of the staff, including loan officers, other officers, or directors, who are not involved with originating or approving the specific credits being assessed and whose compensation is not influenced by the assigned risk ratings. Whether or not the institution has a dedicated credit risk review department, it is prudent for the credit risk review function to report directly to the institution's board of directors or a committee thereof, consistent with safety and soundness standards. Senior management may be responsible for appropriate administrative functions provided such an arrangement does not compromise the independence of the credit risk review function.

The institution's board of directors, or a committee thereof, may outsource the credit risk review function to an independent third party.[11] However, the responsibility for maintaining a sound credit risk review system remains with the institution's board of directors. In any case, institution personnel who are independent from the lending function typically assess risks, develop the credit risk review plan, and verify appropriate follow-up of findings. Outsourcing of the credit risk review function to the institution's external auditor may raise additional independence considerations.[12]

Frequency of Reviews

An effective credit risk review system provides for review and evaluation of an institution's significant loans, loan products, or groups of loans typically annually, on renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality or the existence of one or more other risk factors. The credit risk review function can also provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. Ongoing or periodic review of an institution's loan portfolio is particularly important to the estimation of ACLs or the ALLL because loss expectations may change as the credit quality of a loan changes. Use of key risk indicators or performance metrics by credit risk review management can support adjustments to the frequency and scope of reviews.

Scope of Reviews

Comprehensive and effective reviews cover all segments of the loan portfolio that pose significant credit risk or concentrations, and other loans that meet certain institution-specific criteria. A properly designed scope considers the current market conditions or other external factors that may affect a borrower's current or future ability to repay the loan. Establishment of an appropriate review scope also helps ensure that the sample of loans selected for review, or portfolio segments selected for review, is representative of the portfolio as a whole and provides reasonable assurance that any credit quality deterioration or unfavorable trends are identified. An effective credit risk review function also considers industry standards for credit risk review coverage consistent with the institution's size, complexity, loan types, risk profile, and risk-management practices and helps to verify whether the review scope is appropriate.

11. For supervisory guidance related to outside service providers, refer to SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management."

12. See note 4.

The institution's board of directors or appropriate board committee typically approves the scope of the credit risk review on an annual basis or whenever significant interim changes are made in order to adequately assess the quality of the current portfolio. An effective scope of credit risk review is risk-based and typically includes

- loans over a predetermined size;
- a sufficient sample of smaller loans, new loans, and new loan products;
- loans with higher risk indicators, such as low credit scores, high credit lines, or those credits approved as exceptions to policy;
- segments of loan portfolios, including retail, with similar risk characteristics, such as those related to borrower risk (e.g., credit history), transaction risk (e.g., product and/or collateral type), or other risk factors as appropriate;
- segments of the loan portfolio experiencing rapid growth;
- exposures from non-lending activities that also pose credit risk;
- past due, nonaccrual, renewed, and restructured loans;
- loans previously adversely classified and loans designated as warranting the special attention of the institution's management;[13]
- loans to insiders or related parties (for more information see Regulation O, 12 CFR 215 and this manual's section on Regulation O);
- loans to affiliates (for more information see Regulation W, 12 CFR 223 and this manual's sections on Regulation W); and
- loans constituting concentrations of credit risk and other loans affected by common repayment factors.

Depth of Transaction or Portfolio Reviews

Loans and portfolio segments selected for review are typically evaluated for

- credit quality, soundness of underwriting and risk identification, borrower performance, and adequacy of the sources of repayment;
  — when applicable, this evaluation includes the appropriateness of automated underwriting and credit scoring, including prudent use of overrides as well as the effectiveness of account management strategies, collections, and portfolio management activities in managing credit risk;
- reasonableness of assumptions;
- creditworthiness of guarantors or sponsors;
- sufficiency of credit and collateral documentation;
- proper lien perfection;
- proper approvals consistent with internal policies;
- adherence to loan agreement covenants;
- adequacy of, and compliance with, internal policies and procedures (such as those related to nonaccrual and classification or risk rating policies), laws, and regulations;
- the appropriateness of credit loss estimation for those credits with significant weaknesses including the reasonableness of assumptions used, and the timeliness of charge-offs; and
- the accuracy of risk ratings and the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-Up

An important activity of an effective credit risk review system is the discussion of the review findings, including all noted deficiencies, identified weaknesses, and any existing or planned corrective actions (including time frames for correction) with appropriate loan officers, department managers, and senior management. An effective system includes processes for all noted deficiencies and weaknesses that remain unresolved beyond the scheduled time frames for correction to be promptly reported to senior management and the board of directors or appropriate board committee.

It is important to resolve risk rating differences between loan officers and loan review personnel according to a pre-arranged process. That process may include formal appeals procedures and arbitration by an independent party or may require default to the assigned classification or risk rating that indicates lower credit quality. If credit risk review personnel conclude that a loan or loan portfolio is of a lower credit quality than is perceived by the portfolio management staff, the lower classification or risk rating typically prevails unless internal parties identify additional information sufficient to obtain the concurrence of the independent reviewer or arbiter on the higher credit quality classification or risk rating.

13. See note 8.

Communication and Distribution of Results

Personnel involved in the credit risk review process typically prepare a list of all loans (and portfolio segments) reviewed, the date of review, and a summary analysis that substantiates the risk ratings assigned to the loans reviewed. Effective communication also typically involves providing results of the credit risk reviews to the board of directors or appropriate board committee quarterly.[14] Comprehensive reporting includes comparative trends that identify significant changes in the overall quality of the loan portfolio, the adequacy of, and adherence to, internal policies and procedures, the quality of underwriting and risk identification, compliance with laws and regulations, and management's response to substantive criticisms or recommendations. Such comprehensive reporting provides the board of directors or appropriate board committee with insight into the portfolio and the responsiveness of management and facilitates timely corrective action of deficiencies.

14. An effective credit risk review system provides for informing the board of directors or appropriate board committee more frequently than quarterly when material adverse trends are noted. When an institution conducts loan file reviews less frequently than quarterly, the board or appropriate board committee will typically receive results on other credit risk review activities quarterly.

The allowance for loan and lease losses (ALLL) is presented on the balance sheet as a contra-asset account that reduces the amount of the loan portfolio reported on the balance sheet. The purpose of the ALLL is to reflect *estimated credit losses* within a bank's portfolio of loans and leases. Estimated credit losses are estimates of the current amount of loans that are probable that the bank will be unable to collect given the facts and circumstances since the evaluation date (generally the balance sheet date). That is, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans as of the evaluation date.

All federally insured depository institutions must maintain an ALLL, except for federally insured branches and agencies of foreign banks. A bank determines the appropriate balance or level of the ALLL at least each quarter, periodically validating its methodology for estimating the ALLL (see SR-11-7), and by evaluating the collectibility of its loan and lease portfolio, including any accrued and unpaid interest. Increases or decreases to the ALLL are to be made through charges (debits) or credits to the "provision for loan and lease losses" (provision), an expense account on the bank's Consolidated Report of Income or income statement, and not through transfers from retained earnings or any segregation of retained earnings or other components of equity capital.

When there is information available to confirm that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL. Under no circumstances can loan or lease losses be charged directly to "retained earnings" and capital. Any subsequent recoveries on loans or leases previously charged off must be credited to the ALLL, provided, however, that the total amount credited to the allowance as recoveries of an individual loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

To illustrate these concepts, assume that Bank A has a loan and lease portfolio totaling $100 million at the end of year 1 and an ALLL of $1.25 million; thus, its net carrying amount for the loan portfolio on the balance sheet is $98.75 million. Based on its most recent analysis, Bank A has determined that an ALLL of $1.5 million is necessary to cover its estimated credit losses as of the end of the fourth quarter. Therefore, in the fourth quarter of year 1, Bank A should record a provision for $250,000, debiting this expense and crediting the ALLL for this amount to bring the ALLL to the appropriate level of $1.5 million. Assume further that during the first quarter of year 2, Bank A identifies $750,000 in uncollectible loans. It must charge off this amount against the ALLL by debiting the ALLL and crediting the individual loans for a total of $750,000. Also assume that in the same first quarter of year 2, Bank A receives $100,000 in cash recoveries on previously charged-off loans. These recoveries must be credited to the ALLL in that quarter. Thus, in the first quarter of year 2, Bank A's ALLL, which began the year at $1.5 million, will have been reduced $850,000 ($1,500,000 − $750,000 + $100,000 = $850,000). However, management's ALLL analysis for the first quarter of year 2 indicates that an ALLL of $1.2 million is appropriate. To bring the recorded ALLL to this level, Bank A must make a debit to the provision for loan and lease losses of $350,000 ($850,000 + $350,000 = $1.2 million).

While the overall responsibility for maintaining the ALLL at an appropriate level rests with the bank's senior management and board of directors, the appropriateness of the ALLL and management's analysis of it are subject to examiner review. The examiner should make every effort to fully understand a bank's methods for determining the needed balance of its ALLL. During the process of conducting the examination, the examiner should take these methods into account when making a final determination on the appropriateness (adequacy) of the balance of the ALLL. The examiner may confer with bank management and any outside accountant or auditor that has advised management on its ALLL-review policies or practices.

If the examiner concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. The examiner's comments should cite any departures from generally accepted accounting principles (GAAP) and any contraventions of the following 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses as well as the 2001 policy statement (see "ALLL Methodologies and Documentation"). Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL.

INTERAGENCY POLICY STATEMENT ON THE ALLOWANCE FOR LOAN AND LEASE LOSSES

This 2006 policy statement[1] revises and replaces the 1993 policy statement on the ALLL. It reiterates key concepts and requirements included in generally accepted accounting principles (GAAP) and existing ALLL supervisory guidance.[2] The principal sources of guidance on accounting for impairment in a loan portfolio under GAAP are Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (FAS 5), and Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114). In addition, the Financial Accounting Standards Board Viewpoints article that is included in Emerging Issues Task Force Topic D-80 (EITF D-80), "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio," presents questions and answers that provide specific guidance on the interaction between these two FASB statements and may be helpful in applying them.

In July 1999, the banking agencies and the Securities and Exchange Commission (SEC) issued a Joint Interagency Letter to Financial Institutions. The letter stated that the banking agencies and the SEC agreed on the following important aspects of loan loss allowance practices:

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses.
- Prudent, conservative—but not excessive—loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management's best estimate is at the high end of the range.
- Determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses.
- An "unallocated" loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported.
- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio.
- The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors.

In July 2001, the banking agencies issued the Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (2001 Policy Statement). The policy statement is designed to assist institutions in establishing a sound process for determining an appropriate ALLL and documenting that process in accordance with GAAP.[3] (See "ALLL Methodologies and Documentation.")

In March 2004, the agencies also issued the Update on Accounting for Loan and Lease Losses. This guidance provided reminders of longstanding supervisory guidance as well as a

1. This policy statement was adopted on December 13, 2006, by, and applies to, all depository institutions (institutions), except U.S. branches and agencies of foreign banks, that are supervised by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the banking agencies). U.S. branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

2. As discussed more fully below in the "Nature and Purpose of the ALLL" section, this policy statement and the ALLL generally do not address loans carried at fair value or loans held for sale. In addition, this policy statement provides only limited guidance on "purchased impaired loans."

3. See "ALLL Methodologies and Documentation" for the 2001 Policy Statement. The SEC staff issued parallel guidance in July 2001, which is found in Staff Accounting Bulletin No. 102, "Selected Loan Loss Allowance Methodology and Documentation Issues" (SAB 102), which has been codified as Topic 6.L. in the SEC's Codification of Staff Accounting Bulletins. Both SAB 102 and the codification are available on the SEC's website.

listing of the existing allowance guidance that institutions should continue to apply.

Nature and Purpose of the ALLL

The ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment, and relevant supervisory guidance. As of the end of each quarter, or more frequently if warranted, each institution must analyze the collectibility of its loans and leases held for investment[4] (hereafter referred to as "loans") and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. The ALLL does not apply, however, to loans carried at fair value, loans held for sale,[5] off-balance-sheet credit exposures[6] (for example, financial instruments such as off-balance-sheet loan commitments, standby letters of credit, and guarantees), or general or unspecified business risks.

For purposes of this policy statement, the term *estimated credit losses* means an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances since the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (that is, through a provision to the ALLL) set forth in GAAP.[7] When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL. For "purchased impaired loans,"[8] GAAP prohibits "carrying over" or creating an ALLL in the initial recording of these loans. However, if, upon evaluation subsequent to acquisition, it is probable that the institution will be unable to collect all cash flows expected at acquisition on a purchased impaired loan (an estimate that considers both timing and amount), the loan

4. Consistent with the American Institute of Certified Public Accountants' (AICPA) Statement of Position 01-6, "Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others," loans and leases held for investment are those loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff.

5. See "Interagency Guidance on Certain Loans Held for Sale" (March 26, 2001) for the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account. Loans held for sale are reported at the lower of cost or fair value. Declines in value occurring after the transfer of a loan to the held-for-sale portfolio are accounted for as adjustments to a valuation allowance for held-for-sale loans and not as adjustments to the ALLL.

6. Credit losses on off-balance-sheet credit exposures should be estimated in accordance with FAS 5. Any allowance for credit losses on off-balance-sheet exposures should be reported on the balance sheet as an "other liability," and not as part of the ALLL.

7. FAS 5 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements and the amount of loss can be reasonably estimated. These conditions may be considered in relation to individual loans or in relation to groups of similar types of loans. If the conditions are met, accrual should be made even though the particular loans that are uncollectible may not be identifiable. Under FAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events will occur confirming the fact of the loss. Thus, under GAAP, the purpose of the ALLL is not to absorb all of the risk in the loan portfolio, but to cover probable credit losses that have already been incurred.

8. A *purchased impaired loan* is defined as a loan that an institution has purchased, including a loan acquired in a purchase business combination, that has evidence of deterioration of credit quality since its origination and for which it is probable, at the purchase date, that the institution will be unable to collect all contractually required payments. When reviewing the appropriateness of the reported ALLL of an institution with purchased impaired loans, examiners should consider the credit losses factored into the initial investment in these loans when determining whether further deterioration—for example, decreases in cash flows expected to be collected—has occurred since the loans were purchased. The bank's consolidated reports of condition and income and the disclosures in the bank's financial statements may provide useful information for examiners in reviewing these loans. Refer to the AICPA's Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer," for further guidance on the appropriate accounting.

should be considered impaired for purposes of applying the measurement and other provisions of FAS 5 or, if applicable, FAS 114.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For loans within the scope of FAS 114 that are individually evaluated and determined to be impaired,[9] these estimates should reflect consideration of one of the standard's three impairment measurement methods as of the evaluation date: (1) the present value of expected future cash flows discounted at the loan's effective interest rate,[10] (2) the loan's observable market price, or (3) the fair value of the collateral if the loan is collateral dependent.

An institution may choose the appropriate FAS 114 measurement method on a loan-by-loan basis for an individually impaired loan, except for an impaired collateral-dependent loan. The agencies require impairment of a collateral-dependent loan to be measured using the fair value of collateral method. As defined in FAS 114, a loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral. In general, any portion of the recorded investment in a collateral-dependent loan (including any capitalized accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible, and is therefore deemed a confirmed loss, should be promptly charged off against the ALLL.[11]

All other loans, including individually evaluated loans determined not to be impaired under FAS 114, should be included in a group of loans that is evaluated for impairment under FAS 5.[12] While an institution may segment its loan portfolio into groups of loans based on a variety of factors, the loans within each group should have similar risk characteristics. For example, a loan that is fully collateralized with risk-free assets should not be grouped with uncollateralized loans. When estimating credit losses on each group of loans with similar risk characteristics, an institution should consider its historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans as of the evaluation date.

For analytical purposes, an institution should attribute portions of the ALLL to loans that it evaluates and determines to be impaired under FAS 114 and to groups of loans that it evaluates collectively under FAS 5. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

Responsibilities of the Board of Directors and Management

Appropriate ALLL Level

Each institution's management is responsible for maintaining the ALLL at an appropriate level and for documenting its analysis according to the standards set forth in the 2001 policy statement. Thus, management should evaluate the ALLL reported on the balance sheet as of the end of each quarter or more frequently if warranted, and charge or credit the PLLL to bring the ALLL to an appropriate level as of each evaluation date. The determination of the amounts of the ALLL and the PLLL should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the evaluation date. Management's evaluation is subject to review by examiners. An institution's failure to analyze the collectibility of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice.

In carrying out its responsibility for maintaining an appropriate ALLL, management is expected to adopt and adhere to written policies

9. FAS 114 does not specify how an institution should identify loans that are to be evaluated for collectibility nor does it specify how an institution should determine that a loan is impaired. An institution should apply its normal loan review procedures in making those judgments. Refer to the ALLL interpretations for further guidance.

10. The "effective interest rate" on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan).

11. For further information, refer to the illustration in Appendix B of the 2001 Policy Statement in the section "ALLL Methodologies and Documentation."

12. An individually evaluated loan that is determined not to be impaired under FAS 114 should be evaluated under FAS 5 when specific characteristics of the loan indicate that it is probable there would be estimated credit losses in a group of loans with those characteristics. For further guidance, refer to the frequently asked questions (FAQs) that were distributed with this policy statement.

and procedures that are appropriate to the size of the institution and the nature, scope, and risk of its lending activities. At a minimum, these policies and procedures should ensure that—

- the institution's process for determining an appropriate level for the ALLL is based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio.[13] The analysis should consider all significant factors that affect the collectibility of the portfolio and should support the credit losses estimated by this process.
- the institution has an effective loan review system and controls (including an effective loan classification or credit grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner.[14] To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.
- the institution has adequate data capture and reporting systems to supply the information necessary to support and document its estimate of an appropriate ALLL.
- the institution evaluates any loss estimation models before they are employed and modifies the models' assumptions, as needed, to ensure that the resulting loss estimates are consistent with GAAP. To demonstrate this consistency, the institution should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with the models or other estimation tools. The institution should also document and support any adjustments made to the models or to the output of the models in determining the estimated credit losses.
- the institution promptly charges off loans, or portions of loans, that available information confirms to be uncollectible.
- the institution periodically validates the ALLL methodology. This validation process should be done by a party who is independent of the institution's credit approval and ALLL estimation processes, of the ALLL methodology and its application in order to confirm its effectiveness. See SR 11-7 for more information. A party who is independent of these processes could be the internal audit staff, a risk management unit of the institution, an external auditor (subject to applicable auditor independence standards), or another contracted third party from outside the institution. One party need not perform the entire analysis as the validation can be divided among various independent parties.

The board of directors is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL. This oversight should include but is not limited to—

- reviewing and approving the institution's written ALLL policies and procedures at least annually;
- reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution;
- reviewing management's assessment and justification for the amounts estimated and reported each period for the PLLL and the ALLL; and
- requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

For purposes of the Consolidated Reports of Condition and Income for a Bank (Call Report), an appropriate ALLL (after deducting all loans and portions of loans confirmed loss) should consist only of the following components (as applicable),[15] the amounts of which take into account *all relevant facts and circumstances as of the evaluation date:*

13. As noted in the 2001 Policy Statement, an institution with less complex lending activities and products may find it more efficient to combine a number of procedures while continuing to ensure that the institution has a consistent and appropriate ALLL methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios.

14. Loan review and loan classification or credit grading systems are discussed in this manual's section, "Credit Risk Review Systems." In addition, state member banks should refer to the asset quality standards in the Interagency Guidelines Establishing Standards for Safety and Soundness, which were adopted by the Federal Reserve Board (see Appendix D-1, 12 CFR 208).

15. A component of the ALLL that is labeled "unallocated" is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported and documented.

- For loans within the scope of ASC Topic 310, Receivables (formerly FAS 114, "Accounting by Creditors for Impairment of a Loan") that are individually evaluated and found to be impaired, the associated ALLL should be based upon one of the three impairment measurement methods specified in FAS 114.[16]
- For all other loans, including individually evaluated loans determined not to be impaired under FAS 114,[17] the associated ALLL should be measured under ASC Subtopic 450-20, Contingencies—Loss Contingencies (formerly FAS 5, "Accounting for Contingencies") and should provide for all estimated credit losses that have been incurred on groups of loans with similar risk characteristics.
- For estimated credit losses from transfer risk on cross-border loans, the impact to the ALLL should be evaluated individually for impaired loans under FAS 114 or evaluated on a group basis under FAS 5. See this policy statement's attachment for further guidance on considerations of transfer risk on cross-border loans.
- For estimated credit losses on accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet, the associated ALLL should be evaluated under FAS 114 or FAS 5 as appropriate, if not already included in one of the preceding components.

Because deposit accounts that are overdrawn (that is, overdrafts) must be reclassified as loans on the balance sheet, overdrawn accounts should be included in one of the first two components above, as appropriate, and evaluated for estimated credit losses.

Determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment. Management's analysis should reflect a prudent, conservative, but not excessive ALLL that falls within an acceptable range of estimated credit losses. When a range of losses is determined, institutions should maintain appropriate documentation to support the identified range and the rationale used for determining the best estimate from within the range of loan losses.

It is essential that institutions maintain effective loan review systems. An effective loan review system should work to ensure the accuracy of internal credit classification or grading systems and, thus, the quality of the information used to assess the appropriateness of the ALLL. The complexity and scope of an institution's ALLL evaluation process, loan review system, and other relevant controls should be appropriate for the size of the institution and the nature of its lending activities. The evaluation process should also provide for sufficient flexibility to respond to changes in the factors that affect the collectibility of the portfolio.

Credit losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. In particular, for banks with cross-border lending exposure, management should determine that the ALLL is appropriate to cover estimated losses from transfer risk associated with this exposure over and above any minimum amount that the Interagency Country Exposure Review Committee requires to be provided in the Allocated Transfer Risk Reserve (or charged off against the ALLL). These estimated losses should meet the criteria for accrual of a loss contingency set forth in GAAP. (See the attachment for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. Normally, an institution should determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio based on its own loss experience for loans in that group. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses—or even recent trends in losses—do not by themselves form a sufficient basis to determine the appropriate level for the ALLL. Management also should consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution's existing portfolio to differ from historical loss experience, including but not limited to—

- changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery prac-

16. As previously noted, the use of the fair value of collateral method is required for an individually evaluated loan that is impaired if the loan is collateral dependent.
17. See note 12.

tices not considered elsewhere in estimating credit losses;
- changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments;[18]
- changes in the nature and volume of the portfolio and in the terms of loans;
- changes in the experience, ability, and depth of lending management and other relevant staff;
- changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;[19]
- changes in the quality of the institution's loan review system;
- changes in the value of underlying collateral for collateral-dependent loans;
- the existence and effect of any concentrations of credit, and changes in the level of such concentrations; and
- the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio.

In addition, changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, keeping in mind the characteristics of an institution's loan portfolio. For example, if declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the portfolio should generally decrease.

Measurement of Estimated Credit Losses

FAS 5. When measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with FAS 5, a widely used method is based on each group's historical net charge-off rate adjusted for the effects of the qualitative or environmental factors discussed previously. As the first step in applying this method, management generally bases the historical net charge-off rates on the "annualized" historical gross loan charge-offs, less recoveries, recorded by the institution on loans in each group.

Methodologies for determining the historical net charge-off rate on a group of loans with similar risk characteristics under FAS 5 can range from the simple average of, or a determination of the range of, an institution's annual net charge-off experience to more complex techniques, such as migration analysis and models that estimate credit losses.[20] Generally, institutions should use at least an "annualized" or twelve-month average net charge-off rate that will be applied to the groups of loans when estimating credit losses. However, this rate could vary. For example, loans with effective lives longer than twelve months often have workout periods over an extended period of time, which may indicate that the estimated credit losses should be greater than that calculated based solely on the annualized net charge-off rate for such loans. These groups may include certain commercial loans as well as groups of adversely classified loans. Other groups of loans may have effective lives shorter than twelve months, which may indicate that the estimated credit losses should be less than that calculated based on the annualized net charge-off rate.

Regardless of the method used, institutions should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans. If a range of

18. Credit loss and recovery experience may vary significantly depending upon the stage of the business cycle. For example, an over reliance on credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

19. For banks, adversely classified or graded loans are loans rated "Substandard" (or its equivalent) or worse under its loan classification system.

20. Annual charge-off rates are calculated over a specified time period (for example, three years or five years), which can vary based on a number of factors including the relevance of past periods' experience to the current period or point in the credit cycle. Also, some institutions remove loans that become adversely classified or graded from a group of nonclassified or nongraded loans with similar risk characteristics in order to evaluate the removed loans individually under FAS 114 (if deemed impaired) or collectively in a group of adversely classified or graded loans with similar risk characteristics under FAS 5. In this situation, the net charge-off experience on the adversely classified or graded loans that have been removed from the group of nonclassified or nongraded loans should be included in the historical loss rates for that group of loans. Even though the net charge-off experience on adversely classified or graded loans is included in the estimation of the historical loss rates that will be applied to the group of nonclassified or nongraded loans, the adversely classified or graded loans themselves are no longer included in that group for purposes of estimating credit losses on the group.

historical loss rates is developed instead for a group of loans, institutions should maintain documentation to support the identified range and the rationale for determining which rate is the best estimate within the range of loss rates. The rationale should be based on management's assessment of which rate is most reflective of the estimated credit losses in the current loan portfolio.

After determining the appropriate historical loss rate for each group of loans with similar risk characteristics, management should consider those current qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the FAS 5 component of the ALLL.[21] Both methods are consistent with GAAP, provided the adjustments for qualitative or environmental factors are reasonably and consistently determined, are adequately documented, and represent estimated credit losses. For each group of loans, an institution should apply its adjusted historical loss rate, or its historical loss rate and separate standalone adjustments, to the recorded investment in the group when determining its estimated credit losses.

Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectibility of the institution's loan portfolio as of the evaluation date. Accordingly, institutions should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support which factors affected the analysis and the impact of those factors on the loss measurement. Support and documentation includes descriptions of each factor, management's analysis of how each factor has changed over time, which loan groups' loss rates have been adjusted, the amount by which loss estimates have been adjusted for changes in conditions, an explanation of how management estimated the impact, and other available data that supports the reasonableness of the adjustments. Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

There may be times when an institution does not have its own historical loss experience upon which to base its estimate of the credit losses in a group of loans with similar risk characteristics. This may occur when an institution offers a new loan product or when it is a newly established (that is, de novo) institution. If an institution has no experience of its own for a loan group, reference to the experience of other enterprises in the same lending business may be appropriate, provided the institution demonstrates that the attributes of the group of loans in its portfolio are similar to those of the loan group in the portfolio providing the loss experience. An institution should only use another enterprise's experience on a short-term basis until it has developed its own loss experience for a particular group of loans.

FAS 114. When determining the FAS 114 component of the ALLL for an individually impaired loan,[22] an institution should consider estimated costs to sell the loan's collateral, if any, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the institution bases its measure of loan impairment on the present value of expected future cash flows discounted at the loan's effective interest rate, the estimates of these cash flows should be the institu-

21. An overall adjustment to a portion of the ALLL that is not attributed to specific segments of the loan portfolio is often labeled "unallocated." Regardless of what a component of the ALLL is labeled, it is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported.

22. As noted in FAS 114, some individually impaired loans have risk characteristics that are unique to an individual borrower and the institution will apply the measurement methods on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. An institution may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans.

tion's best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the estimate of expected future cash flows. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. The likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows.

Analyzing the Overall Measurement of the ALLL

Institutions also are encouraged to use ratio analysis as a supplemental tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with an institution's peer group and its own historical experience) in the relationship of the ALLL to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs. Based on such analysis, an institution may identify additional issues or factors that previously had not been considered in the ALLL estimation process, which may warrant adjustments to estimated credit losses. Such adjustments should be appropriately supported and documented.

While ratio analysis, when used prudently, can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses, it is not a sufficient basis for determining the appropriate amount for the ALLL. In particular, because an appropriate ALLL is an institution-specific amount, such comparisons do not obviate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectibility. Furthermore, it is inappropriate for the board of directors or management to make adjustments to the ALLL when it has been properly computed and supported under the institution's methodology for the sole purpose of reporting an ALLL that corresponds to the peer group median, a target ratio, or a budgeted amount. Institutions that have high levels of risk in the loan portfolio or are uncertain about the effect of possible future events on the collectibility of the portfolio should address these concerns by maintaining higher equity capital and not by arbitrarily increasing the ALLL in excess of amounts supported under GAAP.[23]

Estimated Credit Losses in Credit Related Accounts

Typically, institutions evaluate and estimate credit losses for off-balance-sheet credit exposures at the same time that they estimate credit losses for loans. While a similar process should be followed to support loss estimates related to off-balance-sheet exposures, these estimated credit losses are not recorded as part of the ALLL. When the conditions for accrual of a loss under FAS 5 are met, an institution should maintain and report as a separate liability account, an allowance that is appropriate to cover estimated credit losses on off-balance-sheet loan commitments, standby letters of credit, and guarantees. In addition, recourse liability accounts (that arise from recourse obligations on any transfers of loans that are reported as sales in accordance with GAAP) should be reported in regulatory reports as liabilities that are separate and distinct from both the ALLL and the allowance for credit losses on off-balance-sheet credit exposures.

When accrued interest and fees are reported separately on an institution's balance sheet from the related loan balances (that is, as other assets), the institution should maintain an appropriate valuation allowance, determined in accordance with GAAP, for amounts that are not likely to be collected unless management has placed the underlying loans in nonaccrual status and reversed previously accrued interest and fees.[24]

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23. It is inappropriate to use a "standard percentage" as the sole determinant for the amount to be reported as the ALLL on the balance sheet. Moreover, an institution should not simply default to a peer ratio or a "standard percentage" after determining an appropriate level of ALLL under its methodology. However, there may be circumstances when an institution's ALLL methodology and credit risk identification systems are not reliable. Absent reliable data of its own, management may seek data that could be used as a short-term proxy for the unavailable information (for example, an industry average loss rate for loans with similar risk characteristics). This is only appropriate as a short-term remedy until the institution creates a viable system for estimating credit losses within its loan portfolio.

24. See the Call Report instructions for further guidance on placing a loan in nonaccrual status.

Responsibilities of Examiners

Examiners should assess the credit quality of an institution's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the institution's regulatory reports. In their review and classification or grading of the loan portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should do the following:

- Consider the effectiveness of board oversight as well as the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's loan review function and credit grading system. Typically, this will involve testing a sample of the institution's loans. The sample size generally varies and will depend on the nature or purpose of the examination.[25]
- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. In making these evaluations, examiners should ensure that the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and the other factors previously discussed) have been appropriately considered and that management has appropriately applied GAAP, including FAS 114 and FAS 5.
- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances this may include a quantitative analysis (for example, using the types of ratio analysis previously discussed) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.
- Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.
- Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
- Review the interest and fee income accounts associated with the lending process to ensure that the institution's net income is not materially misstated.[26]

As noted in the "Responsibilities of the Board of Directors and Management" section of this policy statement, when assessing the appropriateness of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of management judgment. Even when an institution maintains sound loan administration and collection procedures and an effective loan review system and controls, its estimate of credit losses is not a single precise amount due to the

25. In an examiner's review of an institution's loan review system, the examiner's loan classifications or credit grades may differ from those of the institution's loan review system. If the examiner's evaluation of these differences indicates problems with the loan review system, especially when the loan classification or credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its loan classifications or credit grades to the loan portfolio and to its estimated credit losses. Furthermore, the institution would be expected to improve its loan review system.

26. As noted previously, accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet should be evaluated for estimated credit losses. The accrual of the interest and fee income should also be considered. Refer to GAAP and the Call Report instructions for further guidance on income recognition.

wide range of qualitative or environmental factors that must be considered.

An institution's ability to estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners should generally accept management's estimates when assessing the appropriateness of the institution's reported ALLL, and not seek adjustments to the ALLL, when management has—

- maintained effective loan review systems and controls for identifying, monitoring, and addressing asset quality problems in a timely manner;
- analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner;
- established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL; and
- incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

If the examiner concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. The examiner's comments should cite any departures from GAAP and any contraventions of this policy statement and the 2001 policy statement, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL.

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement and the 2001 policy statement, as applicable, falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of an institution's ALLL is not appropriate, the institution will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on its Call Report to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

Attachment to the Policy Statement—International Transfer Risk Considerations

With respect to international transfer risk, an institution with cross-border exposures should support its determination of the appropriateness of its ALLL by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- the institution's loan portfolio mix for each country (for example, types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors);
- the institution's business strategy and its debt management plans for each country;
- each country's balance of payments position;
- each country's level of international reserves;
- each country's established payment performance record and its future debt servicing prospects;
- each country's socio-political situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt servicing capacity;
- each country's current standing with multilateral and official creditors;
- the status of each country's relationships with other creditors, including institutions; and
- the most recent evaluations distributed by the banking agencies' Interagency Country Exposure Review Committee.

METHODOLOGY

1. Assess the methodology used in determining the appropriate allowance for loan and lease losses (ALLL) and consider whether it includes portfolio segmentation and impairment analysis for individually evaluated loans. (Refer to ASC Subtopic 450-20 and ASC Topic 310.) Determine whether the complexity and scope of the ALLL evaluation process and loan review system are appropriate given the institution's risk profile and complexity of lending activities. Consider the following:
   - the effectiveness of the loan review system and controls
   - the ability of internal data-capture and loan-reporting systems to provide robust and meaningful information regarding portfolio risks
   - management's ability to evaluate loss-estimation models before they are implemented (when applicable) and to modify model assumptions as needed
   - the methodology is based on a comprehensive, adequately documented, and consistently applied analysis of the loan and lease portfolio
   - management promptly charges off loans, or portions of loans, that are uncollectible
   - an independent third party periodically reviews and validates the ALLL methodology
2. Evaluate the criteria management uses to select loans for individual evaluation under ASC Topic 310, such as
   - loans or relationships above a dollar threshold. If management uses a dollar threshold, assess the threshold in relation to average loan balances, concentrations, or other factors that would cause the loans to be more significant to the institution;
   - loans or relationships on the Watch List or adversely classified Substandard or Doubtful. If selection criteria do not include loans rated Substandard or Doubtful, assess the rationale for the decision; and
   - loans or relationships past due or on nonaccrual status.
3. Determine the methodology used by management to measure impairment on loans (within the scope of ASC Topic 310) that are individually evaluated and determined to be impaired, and consider whether management maintains supporting documentation for the assumptions and estimates used. Consider whether the methodology used is based on
   - the present value of expected future cash flows for individually evaluated impaired loans that are not collateral dependent;
   - observable market price for individually evaluated impaired loans that are not collateral dependent; or
   - the fair value of collateral method.[1]
4. Evaluate the reasonableness of and support for management's assumptions, valuations, and judgments used in the analysis of those loans individually evaluated for impairment under ASC Topic 310 and determined to be impaired.
5. Determine how management treats[2]
   - loans individually evaluated for impairment under ASC Topic 310 that are determined not to be impaired; and
   - individually evaluated loans determined to be impaired that are measured with zero impairment (i.e., no allowance is established when measured for impairment under ASC Topic 310).
6. Determine the basis for evaluating groups of loans under ASC Subtopic 450-20.[3]

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1. For Call Report purposes, the impairment of an impaired collateral-dependent loan must be measured using the fair value of collateral method.

2. Examiners should determine that management is appropriately defining impaired loans (i.e., where collection of the full principal and interest is not expected per original contractual terms). If a loan is evaluated under ASC Topic 310 but is not impaired by definition, it should be included in the ASC Subtopic 450-20 evaluation. Once a loan is determined to be impaired and is measured for impairment under ASC Topic 310, it cannot be included in a group of loans collectively assessed for impairment under ASC Subtopic 450-20, even if no ASC Topic 310 allowance is established.

3. Adjustments for qualitative or environmental factors, which may be positive or negative, are typically made to reflect current conditions and expectations as of the balance sheet date if not otherwise captured in historical loss analysis. The granularity of segmentation and the method used to calculate loss rates would affect the amount of adjustment, if any, necessary to appropriately estimate credit losses in a

- Ensure that assets are adequately stratified into groups based on one or more risk characteristics.
- Evaluate the historical loss-rate calculation for each segment.
- Review the time period and the calculation method (e.g., simple average, weighted average) for reasonableness and consistency.
- Consider the effect of new loan products or newly expanded markets.[4]
- Consider how segmentation methods and historical loss-rate calculations reflect qualitative or environmental factors necessary to reflect current conditions and expectations.

7. Determine whether management considers relevant qualitative and environmental factors and maintains documentation sufficient to support material adjustments. Appropriate documentation generally addresses material factors that are likely to cause estimated losses to differ from historical losses. Qualitative or environmental factors may include, but are not limited to
   - changes in lending policies and procedures, such as underwriting standards and collection, charge-off, and recovery practices;
   - changes in national and local economic business conditions and developments, including the condition of various market segments;[5]
   - changes in the nature and volume of the portfolio and in the terms of loans;
   - changes in the experience, ability, and depth of lending management and staff;
   - changes in the volume and severity of past due and adversely classified loans and in the volume of nonaccrual loans;
   - changes in the quality of the loan review system;
   - changes in the value of underlying collateral for collateral-dependent loans;
   - the existence, level, and effect of concentrations of credit; and
   - the effect of external factors, such as competition or legal and regulatory requirements.
8. Determine how management estimates credit losses on a group of loans with similar risk characteristics when the institution does not have any loss experience of its own for such a loan group.[6]
9. Confirm that management does not include loans measured for impairment under ASC 310 in the estimated credit losses under ASC Subtopic 450-20, even if the ASC Topic 310 impairment measurement was zero.
10. If the ALLL includes an *unallocated* amount, determine whether it conforms to generally accepted accounting principles and is properly documented and supported.
11. Where appropriate, determine whether the assessment of an appropriate level for the ALLL includes an estimate of losses from transfer risk associated with cross-border lending activities.
12. Determine whether the ALLL evaluation process is completed at least quarterly and evaluate the documentation maintained to support management's assumptions, valuations, and judgments.[7]

LEVEL OF THE ALLL

13. Evaluate the level of the ALLL or allowances for credit loss (ACL) for loans and leases.
14. Determine whether the ALLL or ACL for loans and leases is appropriate based on a review of the institution's methodology coupled with examination findings as they relate to
    - loan classifications and internal watch list ratings;
    - effectiveness and reliability of the loan review system;
    - level and trend of past due and nonaccrual loans;
    - historical recovery of loan charge-offs;

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segment as of the evaluation date. For example, a loss rate calculated using a simple five-year average may require a larger adjustment in response to changes in the credit cycle than would a loss rate calculated using a recently weighted quarterly average.

4. Historical loss rates for a general segment may not be accurate for new products or loans in a new market that are included in the general segment.

5. Credit loss and recovery experience may vary significantly depending on the business cycle.

6. An institution may not have a loss history if the product is new or the institution is a de novo organization.

7. Refer to the 2001 Final Interagency Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions; and the 2006 Interagency Policy Statement on ALLL.

- lending policies and procedures, such as underwriting, collection, and charge-off and recovery practices; and
- changes in the business cycle that necessitate qualitative or environmental factor adjustments to historical loss rates.

15. Consider reviewing applicable ratios as a preliminary check on the reasonableness of the ALLL or ACL for loans and leases.[8]
    - Evaluate trends compared to historical experience (e.g., the relationship of the ALLL or ACL) for loans and leases to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs.
    - Analyze changes in key ratios from prior periods, assess the directional consistency of the ALLL or ACL for loans and leases in relation to these changes, and assess the appropriateness and reasonableness of the ALLL or ACL for loans and leases based on the collectability of the institution's loan portfolio in the current environment.
16. If the institution's loan review system is effective and the methodology for determining an appropriate ALLL or ACL for loans and leases is acceptable, compare the result of the institution's methodology to the actual ALLL or ACL for loans and leases balance. Ensure that the ALLL or ACL amount for loans and leases reported in the institution's regulatory reports and financial statements reconciles to the ALLL or ACL analysis for loans and leases. Assess the reasons for material differences.
17. Assess management's estimated credit losses, and, if necessary, consider the need for additional provision expenses based on examination findings. Consider whether
    - the loan review system is substantially inaccurate;
    - the institution is lending in stressed market conditions;
    - credit administration and underwriting weaknesses have not been timely identified or addressed; or
    - examination results reflect significant loan quality deterioration.

8. Ratio analysis can be a supplemental check on the reasonableness of management's assumptions and analysis. However, sole use of ratio analysis is insufficient for determining an appropriate level for the ALLL or ACL for loans and leases.

OVERVIEW AND APPLICABILITY

In June 2020, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the National Credit Union Administration (collectively, the agencies) issued an interagency policy statement on allowances for credit losses (ACLs) (hereafter “policy statement”).[1] The agencies issued the policy statement in response to changes to U.S. generally accepted accounting principles (GAAP) as promulgated by the Financial Accounting Standards Board (FASB) in Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and subsequent amendments issued since June 2016. These updates are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments—Credit Losses* (FASB ASC Topic 326).

The policy statement on ACLs describes the measurement of expected credit losses under the current expected credit losses (CECL) methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate ACLs; the responsibilities of boards of directors and management; and examiner reviews of ACLs.

FASB ASC Topic 326 replaces the incurred loss methodology for financial assets measured at amortized cost, net investments in leases, and certain off-balance-sheet credit exposures, and modifies the accounting for impairment on available-for-sale debt securities. FASB ASC Topic 326 applies to all banks, savings associations, credit unions, and financial institution holding companies (collectively, institutions), regardless of size, that file regulatory reports for which the reporting requirements conform to GAAP.[2] The agencies are maintaining conformance with GAAP and consistency with FASB ASC Topic 326 through the issuance of the policy statement on ACLs.[3]

The agencies have issued guidelines establishing standards for safety and soundness, including operational and managerial standards that address such matters as internal controls and information systems, an internal audit system, loan documentation, credit underwriting, asset quality, and earnings that should be appropriate for an institution’s size, complexity, and risk profile.[4] The principles described in the policy statement are consistent with these guidelines.

The policy statement becomes applicable to an institution upon that institution’s adoption of FASB ASC Topic 326.[5] The following policy statements are no longer effective for an institution upon its adoption of FASB ASC Topic 326: the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses;[6] the July 2001 Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.[7] The agencies will rescind the

1. See 88 Fed. Reg. 25,479 (April 27, 2023) and SR-20-12, “Interagency Policy Statement on Allowances for Credit Losses.”

2. See section 37(a) of the Federal Deposit Insurance Act. Under these statutory provisions, the accounting principles applicable to reports or statements required to be filed by all insured depository institutions with the federal banking agencies (the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC)).

3. If the agencies determine that a particular accounting principle within GAAP, including a private company accounting alternative, is inconsistent with the statutorily specified supervisory objectives, those agencies may prescribe an accounting principle for regulatory reporting purposes that is no less stringent than GAAP. In such a situation, an institution would not be permitted to use that particular private company accounting alternative or other accounting principle within GAAP for regulatory reporting purposes.

4. See Appendix D to 12 CFR pt. 208 which was adopted by the Board for depository institutions pursuant to section 39 of the Federal Deposit Insurance Act. *See* 12 U.S.C. 1831p-1.

5. As noted in ASU 2019-10, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, for public business entities that meet the definition of a Securities Exchange Commission (SEC) filer, excluding entities eligible to be small reporting companies as defined by the SEC. FASB ASC Topic 326 is effective for all other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early application of FASB ASC Topic 326 is permitted as set forth in ASU 2016-13.

6. See SR-06-17. The final policy statement does not affect Attachment 1 to the December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses. Attachment 1 has been revised through a separate interagency notice published in 85 Fed. Reg. 33,278 (June 1, 2020). *See also* SR-20-13, “Interagency Guidance on Credit Risk Review Systems.”

7. See SR-01-17.

ALLL Policy Statements once FASB ASC Topic 326 is effective for all institutions.

The agencies issued this Interagency Policy Statement on Allowances for Credit Losses to promote consistency in the interpretation and application of FASB Accounting Standards Update 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* as well as the amendments issued since June 2016.[8] These updates are codified in ASC Topic 326, *Financial Instruments—Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 applies to all institutions, regardless of size, that file regulatory reports for which the reporting requirements conform to U.S. GAAP.[9]

INTERAGENCY POLICY STATEMENT ON ALLOWANCES FOR CREDIT LOSSES

Purpose

The principles described in this policy statement are consistent with GAAP, applicable regulatory reporting requirements,[10] safe and sound banking practices, and the agencies' codified guidelines establishing standards for safety and soundness.[11]

The operational and managerial standards included in those guidelines, which address such matters as internal controls and information systems, an internal audit system, loan documentation, credit underwriting, asset quality, and earnings, should be appropriate for an institution's size and the nature, scope, and risk of its activities.

SCOPE

This policy statement describes the CECL methodology for determining the ACLs applicable to loans held-for-investment, net investments in leases, and held-to-maturity debt securities accounted for at amortized cost.[12] It also describes the estimation of the ACL for an available-for-sale debt security in accordance with FASB ASC Subtopic 326-30. This policy statement does not address or supersede existing agency requirements or guidance regarding appropriate due diligence in connection with the purchase or sale of assets or determining whether assets are permissible to be purchased or held by institutions.[13]

8. The FASB issued Accounting Standards Update (ASU) 2016-13 on June 16, 2016. The following updates were published after the issuance of ASU 2016-13: ASU 2018-19—*Codification Improvements to Topic 326, Financial Instruments—Credit Losses;* ASU 2019-04—*Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments;* ASU 2019-05—*Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief;* ASU 2019-10—*Financial Instruments—Credit Losses (Topic 326), Derivatives and Hedging (Topic 815), and Leases (Topic 842): Effective Dates;* ASU 2019-11—*Codification Improvements to Topic 326, Financial Instruments—Credit Losses and ASU 2022-02—Financial Institutions—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures.* Additionally, institutions may refer to FASB Staff Q&A-Topic 326, No. 1, *Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses,* and FASB Staff Q&A-Topic 326, No. 2, *Developing an Estimate of Expected Credit Losses on Financial Assets.*

9. U.S. branches and agencies of foreign banking organizations may choose to, but are not required to, maintain ACLs on a branch or agency level. These institutions should refer to the instructions for the FFIEC 002, *Report of Assets and Liabilities of U. S. Branches and Agencies of Foreign Banks;* SR-95-4, "Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations"; and SR-95-42, "Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations."

10. For FDIC-insured depository institutions, section 37(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831n(a)) states that, in general, the accounting principles applicable to the Consolidated Reports of Condition and Income (Call Report) "shall be uniform and consistent with generally accepted accounting principles."

11. FDIC-insured depository institutions should refer to the *Interagency Guidelines Establishing Standards for Safety and Soundness* adopted by their primary federal regulator pursuant to section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1): For state member banks, see Appendix D to 12 CFR pt. 208.

12. FASB ASC Topic 326 defines the amortized cost basis as the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, write-offs, foreign exchange, and fair value hedge accounting adjustments.

13. See the final guidance attached to SR-12-15, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings." Under the Federal Reserve Act (12 U.S.C. 335) and the Federal Reserve'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 U.S.C. 24 (Seventh)). Therefore, when investing in securities, state member banks must comply with the provisions of the National Banking Act and the OCC regulations in 12 CFR pt. 1.

The CECL methodology described in FASB ASC Topic 326 applies to financial assets measured at amortized cost, net investments in leases, and off-balance-sheet credit exposures (collectively, financial assets) including

- financing receivables, such as loans held-for-investment;
- overdrawn deposit accounts (i.e., overdrafts) that are reclassified as held-for-investment loans;
- held-to-maturity debt securities;
- receivables that result from revenue transactions within the scope of Topic 606 on revenue from contracts with customers and Topic 610 on other income, which applies, for example, to the sale of foreclosed real estate;
- reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance;
- receivables related to repurchase agreements and securities lending agreements within the scope of Topic 860 on transfers and servicing;
- net investments in leases recognized by a lessor in accordance with Topic 842 on leases; and
- off-balance-sheet credit exposures, including off-balance-sheet loan commitments, standby letters of credit, and financial guarantees not accounted for as insurance, and other similar instruments except for those within the scope of Topic 815 on derivatives and hedging.

The CECL methodology does not apply to the following financial assets:

- financial assets measured at fair value through net income, including those assets for which the fair value option has been elected;
- available-for-sale debt securities;[14]
- loans held-for-sale;
- policy loan receivables of an insurance entity;
- loans and receivables between entities under common control; and
- receivables arising from operating leases.

14. Refer to FASB ASC Subtopic 326-30, Financial Instruments—Credit Losses—Available-for-Sale Debt Securities (FASB ASC Subtopic 326-30).

MEASUREMENT OF ACLs FOR LOANS, LEASES, HELD-TO-MATURITY DEBT SECURITIES, AND OFF-BALANCE-SHEET CREDIT EXPOSURES

Overview of ACLs

An ACL is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term of the assets.[15] In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets.[16] FASB ASC Topic 326 requires management to use relevant forward-looking information and expectations drawn from reasonable and supportable forecasts when estimating expected credit losses.

ACLs are evaluated as of the end of each reporting period. The methods used to determine ACLs generally should be applied consistently over time and reflect management's current expectations of credit losses. Changes to ACLs resulting from these periodic evaluations are recorded through increases or decreases to the related provisions for credit losses (PCLs). When available information confirms that specific loans, securities, other assets, or portions thereof, are uncollectible, these amounts should be promptly written off against the related ACLs.[17]

15. Consistent with FASB ASC Topic 326, an institution's determination of the contractual term should reflect the financial asset's contractual life adjusted for prepayments, and renewal and extension options that are not unconditionally cancellable by the institution. For more information, see the "Contractual Term of a Financial Asset" section in this policy statement.

16. Recoveries are a component of management's estimation of the net amount expected to be collected for a financial asset. Expected recoveries of amounts previously written off or expected to be written off that are included in ACLs may not exceed the aggregate amounts previously written off or expected to be written off. In some circumstances, the ACL for a specific portfolio or loan may be negative because the amount expected to be collected, including expected recoveries, exceeds the financial asset's amortized cost basis.

17. Consistent with FASB ASC Topic 326, this policy statement uses the verbs "write off" and "written off" and the noun "write-off." These terms are used interchangeably with "charge off," "charged off," and "charge-off," respectively, in the agencies' regulations, guidance, and regulatory reporting instructions.

Estimating appropriate ACLs involves a high degree of management judgment and is inherently imprecise. An institution's process for determining appropriate ACLs may result in a range of estimates for expected credit losses. An institution should support and record its best estimate within the range of expected credit losses.

Collective Evaluation of Expected Losses

FASB ASC Topic 326 requires expected losses to be evaluated on a collective, or pool, basis when financial assets share similar risk characteristics. Financial assets may be segmented based on one characteristic, or a combination of characteristics.

Examples of risk characteristics relevant to this evaluation include, but are not limited to

- internal or external credit scores or credit ratings;
- risk ratings or classifications;
- financial asset type;
- collateral type;
- size;
- effective interest rate;
- term;
- geographical location;
- industry of the borrower; and
- vintage.

Other risk characteristics that may be relevant for segmenting held-to-maturity debt securities include issuer, maturity, coupon rate, yield, payment frequency, source of repayment, bond payment structure, and embedded options.

FASB ASC Topic 326 does not prescribe a process for segmenting financial assets for collective evaluation. Therefore, management should exercise judgment when establishing appropriate segments or pools. Management should evaluate financial asset segmentation on an ongoing basis to determine whether the financial assets in the pool continue to share similar risk characteristics. If a financial asset ceases to share risk characteristics with other assets in its segment, it should be moved to a different segment with assets sharing similar risk characteristics if such a segment exists.

If a financial asset does not share similar risk characteristics with other assets, expected credit losses for that asset should be evaluated individually. Individually evaluated assets should not be included in a collective assessment of expected credit losses.

Estimation Methods for Expected Credit Losses

FASB ASC Topic 326 does not require the use of a specific loss estimation method for purposes of determining ACLs. Various methods may be used to estimate the expected collectibility of financial assets, with those methods generally applied consistently over time. The same loss estimation method does not need to be applied to all financial assets. Management is not precluded from selecting a different method when it determines the method will result in a better estimate of ACLs.

Management may use a loss-rate method,[18] probability of default/loss given default (PD/LGD) method, roll-rate method, discounted cash flow method, a method that uses aging schedules, or another reasonable method to estimate expected credit losses. The selected method(s) should be appropriate for the financial assets being evaluated, consistent with the institution's size and complexity.

Contractual Term of a Financial Asset

FASB ASC Topic 326 requires an institution to measure estimated expected credit losses over the contractual term of its financial assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL unless the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution. If such renewal or extension options are present, management must evaluate the likelihood of a borrower exercising those options when determining the contractual term.

18. Various loss-rate methods may be used to estimate expected credit losses under the current expected credit loss methodology. These include the weighted-average-remaining-maturity method, vintage analysis, and the snapshot or open pool method.

Historical Loss Information

Historical loss information generally provides a basis for an institution's assessment of expected credit losses. Historical loss information may be based on internal information, external information, or a combination of both. Management should consider whether the historical loss information may need to be adjusted for differences in current asset specific characteristics such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the reporting date.

Management should then consider whether further adjustments to historical loss information are needed to reflect the extent to which current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical loss period. Adjustments to historical loss information may be quantitative or qualitative in nature and should reflect changes to relevant data (such as changes in unemployment rates, delinquency, or other factors associated with the financial assets).

Reasonable and Supportable Forecasts

When estimating expected credit losses, FASB ASC Topic 326 requires management to consider forward-looking information that is both reasonable and supportable and relevant to assessing the collectibility of cash flows. Reasonable and supportable forecasts may extend over the entire contractual term of a financial asset or a period shorter than the contractual term. FASB ASC Topic 326 does not prescribe a specific method for determining reasonable and supportable forecasts nor does it include bright lines for establishing a minimum or maximum length of time for reasonable and supportable forecast period(s). Judgment is necessary in determining an appropriate period(s) for each institution. Reasonable and supportable forecasts may vary by portfolio segment or individual forecast input. These forecasts may include data from internal sources, external sources, or a combination of both. Management is not required to search for all possible information nor incur undue cost and effort to collect data for its forecasts. However, reasonably available and relevant information should not be ignored in assessing the collectibility of cash flows. Management should evaluate the appropriateness of the reasonable and supportable forecast period(s) each reporting period, consistent with other inputs used in the estimation of expected credit losses.

Institutions may develop reasonable and supportable forecasts by using one or more economic scenarios. FASB ASC Topic 326 does not require the use of multiple economic scenarios; however, institutions are not precluded from considering multiple economic scenarios when estimating expected credit losses.

Reversion

When the contractual term of a financial asset extends beyond the reasonable and supportable period, FASB ASC Topic 326 requires reverting to historical loss information, or an appropriate proxy, for those periods beyond the reasonable and supportable forecast period (often referred to as the reversion period). Management may revert to historical loss information for each individual forecast input or based on the entire estimate of loss.

FASB ASC Topic 326 does not require the application of a specific reversion technique or use of a specific reversion period. Reversion to historical loss information may be immediate, occur on a straight-line basis, or use any systematic, rational method. Management may apply different reversion techniques depending on the economic environment or the financial asset portfolio. Reversion techniques are not accounting policy elections and should be evaluated for appropriateness each reporting period, consistent with other inputs used in the estimation of expected credit losses.

FASB ASC Topic 326 does not specify the historical loss information that is used in the reversion period. This historical loss information may be based on long-term average losses or on losses that occurred during a particular historical period(s). Management may use multiple historical periods that are not sequential. Management should not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods beyond the reasonable and supportable period. However, management should consider whether the historical loss information may need to be adjusted for differences in current asset specific characteristics, such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the reporting date.

Qualitative Factor Adjustments

The estimation of ACLs should reflect consideration of all significant factors relevant to the expected collectibility of the institution's financial assets as of the reporting date. Management may begin the expected credit loss estimation process by determining its historical loss information or obtaining reliable and relevant historical loss proxy data for each segment of financial assets with similar risk characteristics. Historical credit losses (or even recent trends in losses) generally do not, by themselves, form a sufficient basis to determine the appropriate levels for ACLs.

Management should consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. These qualitative factor adjustments may increase or decrease management's estimate of expected credit losses. Adjustments should not be made for information that has already been considered and included in the loss estimation process.

Management should consider the qualitative factors that are relevant to the institution as of the reporting date, which may include, but are not limited to

- the nature and volume of the institution's financial assets;
- the existence, growth, and effect of any concentrations of credit;
- the volume and severity of past due financial assets, the volume of nonaccrual assets, and the volume and severity of adversely classified or graded assets;[19]
- the value of the underlying collateral for loans that are not collateral-dependent;[20]
- the institution's lending policies and procedures, including changes in underwriting standards and practices for collections, write-offs, and recoveries;
- the quality of the institution's credit review function;
- the experience, ability, and depth of the institution's lending, investment, collection, and other relevant management and staff;
- the effect of other external factors, such as the regulatory, legal, and technological environments; competition; and events, such as natural disasters; and
- actual and expected changes in international, national, regional, and local economic and business conditions and developments in which the institution operates that affect the collectibility of financial assets.[21]

Management may consider the following additional qualitative factors specific to held-to-maturity debt securities as of the reporting date:[22]

- the effect of recent changes in investment strategies and policies;
- the existence and effect of loss allocation methods, the definition of default, the impact of performance and market value triggers, and credit and liquidity enhancements associated with debt securities;
- the effect of structural subordination and collateral deterioration on tranche performance of debt securities;
- the quality of underwriting for any collateral backing debt securities; and
- the effect of legal covenants associated with debt securities.

19. For banks and savings associations, adversely classified or graded loans are loans rated "substandard" (or its equivalent) or worse under the institution's loan classification system. For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system, i.e., those loans that tend to be included in the credit union's "watch lists." Criteria related to the classification of an investment security may be found in the interagency policy statement *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions* issued by the FDIC, Board, and OCC in October 2013. *See* SR-13-18.

20. See the "Collateral-Dependent Financial Assets" section of this policy statement for more information on collateral-dependent loans.

21. Changes in economic and business conditions and developments included in qualitative factor adjustments are limited to those that affect the collectibility of an institution's financial assets and are relevant to the institution's financial asset portfolios. For example, an economic factor for current or forecasted unemployment at the national or state level may indicate a strong job market based on low national or state unemployment rates, but a local unemployment rate, which may be significantly higher, for example, because of the actual or forecasted loss of a major local employer may be more relevant to the collectibility of an institution's financial assets.

22. This list is not all-inclusive, and all of the factors listed may not be relevant to all institutions.

Changes in the level of an institution's ACLs may not always be directionally consistent with changes in the level of qualitative factor adjustments due to the incorporation of reasonable and supportable forecasts in estimating expected losses. For example, if improving credit quality trends are evident throughout an institution's portfolio in recent years, but management's evaluation of reasonable and supportable forecasts indicates expected deterioration in credit quality of the institution's financial assets during the forecast period, the ACL as a percentage of the portfolio may increase.

Collateral-Dependent Financial Assets

FASB ASC Topic 326 describes a collateral-dependent asset as a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower, based on management's assessment, is experiencing financial difficulty as of the reporting date. For regulatory reporting purposes, the ACL for a collateral-dependent loan is measured using the fair value of collateral, regardless of whether foreclosure is probable.[23]

When estimating the ACL for a collateral-dependent loan, FASB ASC Topic 326 requires the fair value of collateral to be adjusted to consider estimated costs to sell if repayment or satisfaction of the loan depends on the sale of the collateral. ACL adjustments for estimated costs to sell are not appropriate when the repayment of a collateral-dependent loan is expected from the operation of the collateral.

The fair value of collateral securing a collateral-dependent loan may change over time. If the fair value of the collateral as of the ACL evaluation date has decreased since the previous ACL evaluation date, the ACL should be increased to reflect the additional decrease in the fair value of the collateral. Likewise, if the fair value of the collateral has increased as of the ACL evaluation date, the increase in the fair value of the collateral is reflected through a reduction in the ACL. Any negative ACL that results is capped at the amount previously written off. Changes in the fair value of collateral described herein should be supported and documented through recent appraisals or evaluations.[24]

Purchased Credit-Deteriorated Assets

FASB ASC Topic 326 introduces the concept of purchased credit-deteriorated (PCD) assets. PCD assets are acquired financial assets that, at acquisition, have experienced more-than-insignificant deterioration in credit quality since origination. FASB ASC Topic 326 does not provide a prescriptive definition of more-than-insignificant credit deterioration. The acquiring institution's management should establish and document a reasonable process to consistently determine what constitutes a more-than-insignificant deterioration in credit quality.

When recording the acquisition of PCD assets, the amount of expected credit losses as of the acquisition date is added to the purchase price of the financial assets rather than recording these losses through PCLs. This establishes the amortized cost basis of the PCD assets. Any difference between the unpaid principal balance of the PCD assets and the amortized cost basis of the assets as of the acquisition date is the non-credit discount or premium. The initial ACL and non-credit discount or premium determined on a collective basis at the acquisition date are allocated to the individual PCD assets.

After acquisition, ACLs for PCD assets should be adjusted at each reporting date with a corresponding debit or credit to the PCLs to reflect management's current estimate of expected credit losses. The non-credit discount recorded at acquisition will be accreted into interest income over

23. The agencies, at times, prescribe specific regulatory reporting requirements that fall within a range of acceptable practice under GAAP. These specific reporting requirements, such as the requirement for institutions to apply the practical expedient in ASC 326-20-35-5 for collateral-dependent loans, regardless of whether foreclosure is probable, have been adopted to achieve safety and soundness and other public policy objectives and to ensure comparability among institutions. The regulatory reporting requirement to apply the practical expedient for collateral-dependent financial assets is consistent with the agencies' long-standing practice for collateral-dependent loans, and it continues to be limited to collateral-dependent loans. It does not apply to other financial assets such as held-to-maturity debt securities that are collateral-dependent.

24. For more information on regulatory expectations related to the use of appraisals and evaluations, see the "Interagency Appraisal and Evaluation Guidelines" (SR-10-16) published on December 10, 2010. Insured depository institutions should also refer to the interagency regulations on appraisals adopted by their primary federal regulator. For state member banks, see 12 CFR pts. 208 and 225.

the remaining life of the PCD assets on a level-yield basis.

Financial Assets with Collateral Maintenance Agreements

Institutions may have financial assets that are secured by collateral (such as debt securities) and are subject to collateral maintenance agreements requiring the borrower to continuously replenish the amount of collateral securing the asset. If the fair value of the collateral declines, the borrower is required to provide additional collateral as specified by the agreement.

FASB ASC Topic 326 includes a practical expedient for financial assets with collateral maintenance agreements where the borrower is required to provide collateral greater than or equal to the amortized cost basis of the asset and is expected to continuously replenish the collateral. In those cases, management may elect the collateral maintenance practical expedient and measure expected credit losses for these qualifying assets based on the fair value of the collateral.[25] If the fair value of the collateral is greater than the amortized cost basis of the financial asset and management expects the borrower to replenish collateral as needed, management may record an ACL of zero for the financial asset when the collateral maintenance practical expedient is applied. Similarly, if the fair value of the collateral is less than the amortized cost basis of the financial asset and management expects the borrower to replenish collateral as needed, the ACL is limited to the difference between the fair value of the collateral and the amortized cost basis of the asset as of the reporting date when applying the collateral maintenance practical expedient.

Accrued Interest Receivable

FASB ASC Topic 326 includes accrued interest receivable in the amortized cost basis of a financial asset. As a result, accrued interest receivable is included in the amounts for which ACLs are estimated. Generally, any accrued interest receivable that is not collectible is written off against the related ACL.

FASB ASC Topic 326 permits a series of independent accounting policy elections related to accrued interest receivable that alter the accounting treatment described in the preceding paragraph. These elections are made upon adoption of FASB ASC Topic 326 and may differ by class of financing receivable or major security-type level. The available accounting policy elections[26] are

- management may elect not to measure ACLs for accrued interest receivable if uncollectible accrued interest is written off in a timely manner. Management should define and document its definition of a timely write-off.
- management may elect to write off accrued interest receivable by either reversing interest income, recognizing the loss through PCLs, or through a combination of both methods.
- management may elect to separately present accrued interest receivable from the associated financial asset in its regulatory reports and financial statements, if applicable. The accrued interest receivable is presented net of ACLs (if any).

Financial Assets with Zero Credit Loss Expectations

There may be certain financial assets for which the expectation of credit loss is zero after evaluating historical loss information, making necessary adjustments for current conditions and reasonable and supportable forecasts, and considering any collateral or guarantee arrangements that are not free-standing contracts. Factors to consider when evaluating whether expectations of zero credit loss are appropriate may include, but are not limited to

- a long history of zero credit loss;
- a financial asset that is fully secured by cash or cash equivalents;

25. For example, an institution enters into a reverse repurchase agreement with a collateral maintenance agreement. Management may not need to record the expected credit losses at each reporting date as long as the fair value of the security collateral is greater than the amortized cost basis of the reverse repurchase agreement. Refer to ASC 326-20-55-46 for more information.

26. The accounting policy elections related to accrued interest receivable that are described in this paragraph also apply to accrued interest receivable for an available-for-sale debt security that, for purposes of identifying and measuring an impairment, exclude the applicable accrued interest from both the fair value and amortized cost basis of the securities.

- high credit ratings from rating agencies with no expected future downgrade;[27]
- principal and interest payments that are guaranteed by the U.S. government;
- The issuer, guarantor, or sponsor can print its own currency and the currency is held by other central banks as reserve currency; and
- The interest rate on the security is recognized as a risk-free rate.

A loan that is fully secured by cash or cash equivalents, such as certificates of deposit issued by the lending institution, would likely have zero credit loss expectations. Similarly, the guaranteed portion of a U.S. Small Business Administration (SBA) loan or security purchased on the secondary market through the SBA's fiscal and transfer agent would likely have zero credit loss expectations if these financial assets are unconditionally guaranteed by the U.S. government. Examples of held-to-maturity debt securities that may result in expectations of zero credit loss include U.S. Treasury securities as well as mortgage-backed securities issued and guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. Assumptions related to zero credit loss expectations should be included in the institution's ACL documentation.

Estimated Credit Losses for Off-Balance-Sheet Credit Exposures

FASB ASC Topic 326 requires that an institution estimate expected credit losses for off-balance-sheet credit exposures within the scope of FASB ASC Topic 326 over the contractual period during which the institution is exposed to credit risk. The estimate of expected credit losses should take into consideration the likelihood that funding will occur as well as the amount expected to be funded over the estimated remaining contractual term of the off-balance-sheet credit exposures. Management should not record an estimate of expected credit losses for off-balance-sheet exposures that are unconditionally cancellable by the issuer.

Management must evaluate expected credit losses for off-balance-sheet credit exposures as of each reporting date. While the process for estimating expected credit losses for these exposures is similar to the one used for on-balance-sheet financial assets, these estimated credit losses are not recorded as part of the ACLs because cash has not yet been disbursed to fund the contractual obligation to extend credit. Instead, these loss estimates are recorded as a liability, separate and distinct from the ACLs.[28] The amount needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures as of each reporting date is reported in net income.

MEASUREMENT OF THE ACL FOR AVAILABLE-FOR-SALE DEBT SECURITIES

FASB ASC Subtopic 326-30, *Financial Instruments—Credit Losses—Available-for-Sale Debt Securities* (FASB ASC Subtopic 326-30) describes the accounting for expected credit losses associated with available-for-sale debt securities. Credit losses for available-for-sale debt securities are evaluated as of each reporting date when the fair value is less than amortized cost. FASB ASC Subtopic 326-30 requires credit losses to be calculated individually, rather than collectively, using a discounted cash flow method, through which management compares the present value of expected cash flows with the amortized cost basis of the security. An ACL is established, with a charge to the PCL, to reflect the credit loss component of the decline in fair value below amortized cost. If the fair value of the security increases over time, any ACL that has not been written off may be reversed through a credit to the PCL. The ACL for an available-for-sale debt security is limited by the amount that the fair value is less than the amortized cost, which is referred to as the fair value floor.

If management intends to sell an available-for-sale debt security or will more likely than not be required to sell the security before recovery of the amortized cost basis, the security's ACL should be written off and the amortized

27. Management should not rely solely on credit rating agencies but should also make its own assessment based on third party research, default statistics, and other data that may indicate a decline in credit rating.

28. The ACL associated with off-balance-sheet credit exposures is included in the "Allowance for credit losses on off-balance-sheet credit exposures" in *Schedule RC-G—Other Liabilities* in the Call Report.

cost basis of the security should be written down to its fair value at the reporting date with any incremental impairment reported in income.

A change during the reporting period in the non-credit component of any decline in fair value below amortized cost on an available-for-sale debt security is reported in other comprehensive income, net of applicable income taxes.[29]

When evaluating impairment for available-for-sale debt securities, management may evaluate the amortized cost basis including accrued interest receivable, or may evaluate the accrued interest receivable separately from the remaining amortized cost basis. If evaluated separately, accrued interest receivable is excluded from both the fair value of the available-for-sale debt security and its amortized cost basis.[30]

DOCUMENTATION STANDARDS

For financial and regulatory reporting purposes, ACLs and PCLs must be determined in accordance with GAAP. ACLs and PCLs should be well documented, with clear explanations of the supporting analyses and rationale. Sound policies, procedures, and control systems should be appropriately tailored to an institution's size and complexity, organizational structure, business environment and strategy, risk appetite, financial asset characteristics, loan administration procedures, investment strategy, and management information systems.[31] Maintaining, analyzing, supporting, and documenting appropriate ACLs and PCLs in accordance with GAAP is consistent with safe and sound banking practices.

The policies and procedures governing an institution's ACL processes and the controls over these processes should be designed, implemented, and maintained to reasonably estimate expected credit losses for financial assets and off-balance-sheet credit exposures as of the reporting date. The policies and procedures should describe management's processes for evaluating the credit quality and collectibility of financial asset portfolios, including reasonable and supportable forecasts about changes in the credit quality of these portfolios, through a disciplined and consistently applied process that results in an appropriate estimate of the ACLs. Management should review and, as needed, revise the institution's ACL policies and procedures at least annually, or more frequently if necessary.

An institution's policies and procedures for the systems, processes, and controls necessary to maintain appropriate ACLs should address, but not be limited to

- processes that support the determination and maintenance of appropriate levels for ACLs that are based on a comprehensive, well-documented, and consistently applied analysis of an institution's financial asset portfolios and off-balance-sheet credit exposures. The analyses and loss estimation processes used should consider all significant factors that affect the credit risk and collectibility of the financial asset portfolios;
- the roles, responsibilities, and segregation of duties of the institution's senior management and other personnel who provide input into ACL processes, determine ACLs, or review ACLs. These departments and individuals may include accounting, financial reporting, treasury, investment management, lending, special asset or problem loan workout teams, retail collections and foreclosure groups, credit review, model risk management, internal audit, and others, as applicable. Individuals with responsibilities related to the estimation of ACLs should be competent and well-trained, with the ability to escalate material issues;
- processes for determining the appropriate historical period(s) to use as the basis for estimating expected credit losses and approaches for adjusting historical credit loss information to reflect differences in asset specific characteristics as well as current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period(s);
- processes for determining and revising the appropriate techniques and periods to revert to historical credit loss information when the contractual term of a financial asset or off-

29. Non-credit impairment on an available-for-sale debt security that is not required to be recorded through the ACL should be reported in other comprehensive income as described in ASC 326-30-35-2.

30. The accounting policy elections described in the "Accrued Interest Receivable" section of this policy statement apply to accrued interest receivable recorded for an available-for-sale debt security if an institution excludes applicable accrued interest receivable from both the fair value and amortized cost basis of the security for purposes of identifying and measuring impairment.

31. Management often documents policies, procedures, and controls related to ACLs in accounting or credit risk management policies, or a combination thereof.

balance-sheet credit exposure extends beyond the reasonable and supportable forecast period(s);
- processes for segmenting financial assets for estimating expected credit losses and periodically evaluating the segments to determine whether the assets continue to share similar risk characteristics;
- data capture and reporting systems that supply the quality and breadth of relevant and reliable information necessary, whether obtained internally or externally, to support and document the estimates of appropriate ACLs for regulatory reporting requirements and, if applicable, financial statement and disclosure requirements;
- the description of the institution's systematic and logical loss estimation process(es) for determining and consolidating expected credit losses to ensure that the ACLs are recorded in accordance with GAAP and regulatory reporting requirements. This may include, but is not limited to
  - — management's judgments, accounting policy elections, and application of practical expedients in determining the amount of expected credit losses;
  - — the process for determining when a loan is collateral-dependent;
  - — the process for determining the fair value of collateral, if any, used as an input when estimating the ACL, including the basis for making any adjustments to the market value conclusion and how costs to sell, if applicable, are calculated;
  - — the process for determining when a financial asset has zero credit loss expectations;
  - — the process for determining expected credit losses when a financial asset has a collateral maintenance provision; and
  - — a description of and support for qualitative factors that affect collectibility of financial assets;
- procedures for validating and independently reviewing the loss estimation process as well as any changes to the process from prior periods;
- policies and procedures for the prompt write-off of financial assets, or portions of financial assets, when available information confirms the assets to be uncollectible, consistent with regulatory reporting requirements; and
- the systems of internal controls used to confirm that the ACL processes are maintained and periodically adjusted in accordance with GAAP and interagency guidelines establishing standards for safety and soundness.

Internal control systems for the ACL estimation processes should

- provide reasonable assurance regarding the relevance, reliability, and integrity of data and other information used in estimating expected credit losses;
- provide reasonable assurance of compliance with laws, regulations, and the institution's policies and procedures;
- provide reasonable assurance that the institution's financial statements are prepared in accordance with GAAP, and the institution's regulatory reports are prepared in accordance with the applicable instructions;
- include a well-defined and effective loan review and grading process that is consistently applied and identifies, measures, monitors, and reports asset quality problems in an accurate, sound and timely manner. The loan review process should respond to changes in internal and external factors affecting the level of credit risk in the portfolio; and
- include a well-defined and effective process for monitoring credit quality in the debt securities portfolio.

ANALYZING AND VALIDATING THE OVERALL MEASUREMENT OF ACLs

To ensure that ACLs are presented fairly, in accordance with GAAP and regulatory reporting requirements, and are transparent for regulatory examinations, management should document its measurements of the amounts of ACLs reported in regulatory reports and financial statements, if applicable, for each type of financial asset (e.g., loans, held-to-maturity debt securities, and available-for-sale debt securities) and for off-balance-sheet credit exposures. This documentation should include ACL calculations, qualitative adjustments, and any adjustments to the ACLs that are required as part of the internal review and challenge process. The board of directors, or a committee thereof, should review management's assessments of and justifications for the reported amounts of ACLs.

Various techniques are available to assist management in analyzing and evaluating the ACLs. For example, comparing estimates of expected credit losses to actual write-offs in aggregate, and by portfolio, may enable management to assess whether the institution's loss estimation process is sufficiently designed.[32] Further, comparing the estimate of ACLs to actual write-offs at the financial asset portfolio level allows management to analyze changing portfolio characteristics, such as the volume of assets or increases in write-off rates, which may affect future forecast adjustments. Techniques applied in these instances do not have to be complex to be effective but, if used, should be commensurate with the institution's size and complexity.

Ratio analysis may also be useful for evaluating the overall reasonableness of ACLs. Ratio analysis assists in identifying divergent or emerging trends in the relationship of ACLs to other factors, such as adversely classified or graded loans, past due and nonaccrual loans, total loans, historical gross write-offs, net write-offs, and historic delinquency and default trends for securities.

Comparing the institution's ACLs to those of peer institutions may provide management with limited insight into management's own ACL estimates. Management should apply caution when performing peer comparisons as there may be significant differences among peer institutions in the mix of financial asset portfolios, reasonable and supportable forecast period assumptions, reversion techniques, the data used for historical loss information, and other factors.

When used prudently, comparisons of estimated expected losses to actual write-offs, ratio analysis, and peer comparisons can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses. Because appropriate ACLs are institution-specific estimates, the use of comparisons does not eliminate the need for a comprehensive analysis of financial asset portfolios and the factors affecting their collectibility.

When an appropriate expected credit loss framework has been used to estimate expected credit losses, it is inappropriate for the board of directors or management to make further adjustments to ACLs for the sole purpose of reporting ACLs that correspond to a peer group median, a target ratio, or a budgeted amount. Additionally, neither the board of directors nor management should further adjust ACLs beyond what has been appropriately measured and documented in accordance with FASB ASC Topic 326.

After analyzing ACLs, management should periodically validate the loss estimation process, and any changes to the process, to confirm that the process remains appropriate for the institution's size, complexity, and risk profile. The validation process should include procedures for review by a party with appropriate knowledge, technical expertise, and experience who is independent of the institution's credit approval and ACL estimation processes. A party who is independent of these processes could be from internal audit staff, a risk management unit of the institution independent of management supervising these processes, or a contracted third-party. One party need not perform the entire analysis as the validation may be divided among various independent parties.[33]

RESPONSIBILITIES OF THE BOARD OF DIRECTORS

The board of directors, or a committee thereof, is responsible for overseeing management's significant judgments and estimates used in determining appropriate ACLs. Evidence of the board of directors' oversight activities is subject to review by examiners. These activities should include, but are not limited to

- retaining experienced and qualified management to oversee all ACL and PCL activities;
- reviewing and approving the institution's written loss estimation policies, including any revisions thereto, at least annually;
- reviewing management's assessment of the loan review system and management's conclusion and support for whether the system is sound and appropriate for the institution's size and complexity;

32. Institutions using models in the loss estimation process may incorporate a qualitative factor adjustment in the estimate of expected credit losses to capture the variance between modeled credit loss expectations and actual historical losses when the model is still considered predictive and fit for use. Institutions should monitor this variance, as well as changes to the variance, to determine if the variance is significant or material enough to warrant further changes to the model.

33. Engaging the institution's external auditor to perform the validation process described in this paragraph when the external auditor also conducts the institution's independent financial statement audit, may impair the auditor's independence under applicable auditor independence standards and prevent the auditor from performing an independent audit of the institution's financial statements.

- reviewing management's assessment of the effectiveness of processes and controls for monitoring the credit quality of the investment portfolio;
- reviewing management's assessments of and justifications for the estimated amounts reported each period for the ACLs and the PCLs;
- requiring management to validate, and, when appropriate, revise loss estimation methods periodically;
- approving the internal and external audit plans for the ACLs, as applicable; and
- reviewing any identified audit findings and monitoring resolution of those items.

RESPONSIBILITIES OF MANAGEMENT

Management is responsible for maintaining ACLs at appropriate levels and for documenting its analyses in accordance with the concepts and requirements set forth in GAAP, regulatory reporting requirements, and this policy statement. Management should evaluate the ACLs reported on the balance sheet as of the end of each period, and debit or credit the related PCLs to bring the ACLs to an appropriate level as of each reporting date. The determination of the amounts of the ACLs and the PCLs should be based on management's current judgments about the credit quality of the institution's financial assets and should consider known and expected relevant internal and external factors that significantly affect collectibility over reasonable and supportable forecast periods for the institution's financial assets as well as appropriate reversion techniques applied to periods beyond the reasonable and supportable forecast periods. Management's evaluations are subject to review by examiners.

In carrying out its responsibility for maintaining appropriate ACLs, management should adopt and adhere to written policies and procedures that are appropriate to the institution's size and the nature, scope, and risk of its lending and investing activities. These policies and procedures should address the processes and activities described in the "Documentation Standards" section of this policy statement.

Management fulfills other responsibilities that aid in the maintenance of appropriate ACLs. These activities include, but are not limited to

- establishing and maintaining appropriate governance activities for the loss estimation process(es). These activities may include reviewing and challenging the assumptions used in estimating expected credit losses and designing and executing effective internal controls over the credit loss estimation method(s);
- periodically performing procedures that compare credit loss estimates to actual write-offs, at the portfolio level and in aggregate, to confirm that amounts recorded in the ACLs were sufficient to cover actual credit losses. This analysis supports that appropriate ACLs were recorded and provides insight into the loss estimation process's ability to estimate expected credit losses. This analysis is not intended to reflect the accuracy of management's economic forecasts;
- periodically validating the loss estimation process(es), including changes, if any, to confirm it is appropriate for the institution; and
- engaging in sound risk management of third parties involved in ACL estimation process(es), if applicable, to ensure that the loss estimation processes are commensurate with the level of risk, the complexity of the third-party relationship and the institution's organizational structure.[34]

Additionally, if an institution uses loss estimation models in determining expected credit losses, management should evaluate the models before they are employed and modify the model logic and assumptions, as needed, to help ensure that the resulting loss estimates are consistent with GAAP and regulatory reporting requirements.[35] To demonstrate such consistency, management should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with models. When used for multiple purposes within an institution, models should be specifically adjusted and validated for use in ACL loss estimation processes. Management should document and support any adjustments made to the models, the outputs of

34. Guidance on third party service providers may be found in SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management."

35. See the interagency statement titled, "Guidance on Model Risk Management," (SR-11-7). The statement also addresses the incorporation of vendor products into an institution's model risk management framework following the same principles relevant to in-house models.

the models, and compensating controls applied in determining the estimated expected credit losses.

EXAMINER REVIEW OF ACLs

Examiners are expected to assess the appropriateness of management's loss estimation processes and the appropriateness of the institution's ACL balances as part of their supervisory activities. The review of ACLs, including the depth of the examiner's assessment, should be commensurate with the institution's size, complexity, and risk profile. As part of their supervisory activities, examiners generally assess the credit quality and credit risk of an institution's financial asset portfolios, the adequacy of the institution's credit loss estimation processes, the adequacy of supporting documentation, and the appropriateness of the reported ACLs and PCLs in the institution's regulatory reports and financial statements, if applicable. Examiners may consider the significant factors that affect collectibility, including the value of collateral securing financial assets and any other repayment sources. Supervisory activities may include evaluating management's effectiveness in assessing credit risk for debt securities (both prior to purchase and on an on-going basis). In reviewing the appropriateness of an institution's ACLs, examiners may

- evaluate the institution's ACL policies and procedures and assess the loss estimation method(s) used to arrive at overall estimates of ACLs, including the documentation supporting the reasonableness of management's assumptions, valuations, and judgments. Supporting activities may include, but, are not limited to
  - — evaluating whether management has appropriately considered historical loss information, current conditions, and reasonable and supportable forecasts, including significant qualitative factors that affect the collectibility of the financial asset portfolios;
  - — assessing loss estimation techniques, including loss estimation models, if applicable, as well as the incorporation of qualitative adjustments to determine whether the resulting estimates of expected credit losses are in conformity with GAAP and regulatory reporting requirements; and
  - — evaluating the adequacy of the documentation and the effectiveness of the controls used to support the measurement of the ACLs;
- assess the effectiveness of board oversight as well as management's effectiveness in identifying, measuring, monitoring, and controlling credit risk. This may include, but is not limited to, a review of underwriting standards and practices, portfolio composition and trends, credit risk review functions, risk rating systems, credit administration practices, investment securities management practices, and related management information systems and reports;
- review the appropriateness and reasonableness of the overall level of the ACLs relative to the level of credit risk, the complexity of the institution's financial asset portfolios, and available information relevant to assessing collectibility, including consideration of current conditions and reasonable and supportable forecasts. Examiners may include a quantitative analysis (e.g., using management's results comparing expected write-offs to actual write-offs as well as ratio analysis) to assess the appropriateness of the ACLs. This quantitative analysis may be used to determine the reasonableness of management's assumptions, valuations, and judgments and understand variances between actual and estimated credit losses. Loss estimates that are consistently and materially over or under predicting actual losses may indicate a weakness in the loss forecasting process;
- review the ACLs reported in the institution's regulatory reports and in any financial statements and other key financial reports to determine whether the reported amounts reconcile to the institution's estimate of the ACLs. The consolidated loss estimates determined by the institution's loss estimation method(s) should be consistent with the final ACLs reported in its regulatory reports and financial statements, if applicable;
- verify that models used in the loss estimation process, if any, are subject to initial and ongoing validation activities. Validation activities include evaluating and concluding on the conceptual soundness of the model, including developmental evidence, performing ongoing monitoring activities, including process verification and benchmarking, and analyzing

model output.[36] Examiners may review model validation findings, management's response to those findings, and applicable action plans to remediate any concerns, if applicable. Examiners may also assess the adequacy of the institution's processes to implement changes in a timely manner; and

- review the effectiveness of the institution's third-party risk management framework associated with the estimation of ACLs, if applicable, to assess whether the processes are commensurate with the level of risk, the complexity and nature of the relationship, and the institution's organizational structure. Examiners may determine whether management monitors material risks and deficiencies in third-party relationships, and takes appropriate action as needed.[37]

When assessing the appropriateness of ACLs, examiners should recognize that the processes, loss estimation methods, and underlying assumptions an institution uses to calculate ACLs require the exercise of a substantial degree of management judgment. Even when an institution maintains sound procedures, controls, and monitoring activities, an estimate of expected credit losses is not a single precise amount and may result in a range of acceptable outcomes for these estimates. This is a result of the flexibility FASB ASC Topic 326 provides institutions in selecting loss estimation methods and the wide range of qualitative and forecasting factors that are considered.

36. See SR-11-7.
37. See SR-23-4.

Management's ability to estimate expected credit losses should improve over the contractual term of financial assets as substantive information accumulates regarding the factors affecting repayment prospects. Examiners generally should accept an institution's ACL estimates and not seek adjustments to the ACLs, when management has provided adequate support for the loss estimation process employed, and the ACL balances and the assumptions used in the ACL estimates are in accordance with GAAP and regulatory reporting requirements. It is inappropriate for examiners to seek adjustments to ACLs for the sole purpose of achieving ACL levels that correspond to a peer group median, a target ratio, or a benchmark amount when management has used an appropriate expected credit loss framework to estimate expected credit losses.

If the examiner concludes that an institution's reported ACLs are not appropriate or determines that its ACL evaluation processes or loss estimation method(s) are otherwise deficient, these concerns should be noted in the report of examination and communicated to the board of directors and senior management.[38] Additional supervisory action may be taken based on the magnitude of the shortcomings in ACLs, including the materiality of any errors in the reported amounts of ACLs.

38. Each agency has formal and informal communication channels for sharing supervisory information with the board of directors and management depending on agency practices and the nature of the information being shared. These channels may include, but are not limited to, institution specific supervisory letters, letters to the industry, transmittal letters, visitation findings summary letters, targeted review conclusion letters, or official examination or inspection reports.

METHODOLOGY

1. Determine the methodology or methodologies used to measure the expected collectability of loans, and consider whether management maintains supporting documentation for the assumptions and estimates used. Methodologies include
   - loss-rate;
   - weighted-average-remaining-maturity (WARM);
   - probability of default/loss given default (PD/LGD);
   - roll-rate;
   - discounted cash flow;
   - a method that uses aging schedules;
   - fair value of the collateral (required for all collateral-dependent loans); and
   - another reasonable method to estimate expected credit losses.
2. Assess the methodology or methodologies used in determining an appropriate allowance for credit loss (ACL) for loans and leases. Determine whether the complexity and scope of the ACL evaluation process for loans and leases and the loan review system are appropriate given the institution's risk profile and complexity of lending activities. Consider whether management provides for the following:
   - an effective loan review system and controls;
   - data-capture and loan-reporting systems that provide meaningful information regarding portfolio risks to support and document the estimates of an appropriate ACL for loans and leases for regulatory reporting requirements and, if applicable, financial statement and disclosure requirements;
   - resources to appropriately evaluate loss-estimation models before they are implemented (when applicable) and to modify model assumptions as needed;
   - processes that support the determination and maintenance of an appropriate level for the ACL for loans and leases that are based on a comprehensive, well-documented, and consistently applied analysis of the loan and lease portfolio and off-balance-sheet credit exposures;
   - procedures for an independent third party to review and validate the ACL methodology for loans and leases;
   - processes for determining the appropriate historical period(s) to use as the basis for estimating expected credit losses and approaches for adjusting historical credit loss information to reflect differences in loan specific characteristics, as well as current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period(s);
   - procedures to incorporate relevant internal and external factors that significantly affect collectability over reasonable and supportable forecast periods as well as to apply appropriate reversion techniques to periods beyond reasonable and supportable forecast periods;
   - processes for determining and revising the appropriate techniques and periods to revert to historical credit loss information when the contractual term of loans and leases or off-balance-sheet credit exposures extends beyond the reasonable and supportable forecast period(s);
   - processes for segmenting the loan and lease portfolio for estimating expected credit losses and periodically evaluating the segments to determine whether the loans and leases continue to share similar risk characteristics; and
   - policies and procedures for the prompt write-off of loans and leases, or portions of loans and leases, when available information confirms the loans and leases to be uncollectible, consistent with regulatory reporting requirements.
3. Evaluate the criteria management uses to segment loans by similar risk characteristics. Generally accepted accounting principles (GAAP) require expected losses to be evaluated collectively when loans share similar risk characteristics. If a loan does not share similar risk characteristics with other loans, expected credit losses for that loan should be evaluated individually. Examples of risk characteristics include but are not limited to

   - internal or external credit scores or credit ratings;
   - risk ratings or classifications;
   - loan type;
   - collateral type;
   - size;
   - effective interest rate;
   - term;
   - geographical location;
   - borrower industry; and
   - vintage.
4. Evaluate the policies and procedures for the ACL for loans and leases, and assess the loss estimation method(s) used to arrive at estimates of the ACL for loans and leases, including the documentation supporting management's assumptions, valuations, and judgments. Determine whether management appropriately considers historical loss information, current conditions, and reasonable and supportable forecasts that are relevant to assessing the collectability of cash flows, including significant qualitative factors that affect the collectability of the loan and lease portfolio.
5. Determine the basis for evaluating groups of loans under ASC Subtopic 326-20 (CECL).[1]
   - Evaluate the calculation of historical loss rates for each segment.[2]
   - Review the time period and the method of calculation (e.g., simple average, weighted average) for reasonableness and consistency.[3]
   - Consider whether the historical loss information may need to be adjusted for differences in current loan specific characteristics, such as differences in underwriting standards, portfolio mix, or when historical credit terms do not reflect the contractual terms of the loans being evaluated as of the reporting date.
   - Consider the effect of new loan products or newly expanded markets.[4]
   - Consider how segmentation methods and historical loss-rate calculations reflect the extent to which current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical loss period.
   - Consider management's process for evaluating contractual terms of loans, considering expected prepayments.[5]
6. Determine whether management considered all significant factors relevant to the expected collectability of the loan and lease portfolio as of the reporting date and maintains documentation sufficient to support all material adjustments. Appropriate documentation generally addresses all material factors that are relevant to the institution at the reporting date.[6] Qualitative or environmental factors may include
   - the nature and volume of the loans and leases;
   - the existence, growth, and effect of concentrations of credit;
   - the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;
   - the value of the underlying collateral for loans that are not collateral-dependent;
   - the institution's lending policies and procedures, including changes in underwriting standards and collections, charge-off, and recovery practices;
   - the quality of the institution's credit review system;

1. Adjustments to historical loss information may be positive or negative, quantitative or qualitative, and are supported by relevant data (e.g., changes in unemployment rates, delinquency, or other factors associated with the loans).

2. The granularity of segmentation and the method used to calculate loss rates affects the amount of adjustment, if any, necessary to appropriately estimate credit losses in a segment as of the evaluation date. For example, a loss rate calculated using a simple five-year average may require a larger adjustment in response to changes in the credit cycle than would a loss rate calculated using a recently weighted quarterly average.

3. Historical loss information may be based on internal information, external information, or a combination of both.

4. Historical loss rates for new products or loans in a new market may not be reliable given lack of seasoning or market awareness.

5. Renewals, extensions, and modifications are excluded from the contractual term of a loan for purposes of estimating the ACL for loans and leases unless there is a reasonable expectation of executing a troubled debt restructuring or the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution.

6. Historical credit losses (or even recent trends in losses) generally do not, by themselves, form a sufficient basis to determine the appropriate level of the ACL for loans and leases. Management should consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. These qualitative factor adjustments may increase or decrease management's estimate of expected credit losses. Adjustments should not be made for information that has already been considered and included in the loss estimation process.

- the experience, ability, and depth of the lending, collection, and other relevant management and staff;
- the effect of other external factors, such as the regulatory, legal, and technological environments; competition; and events, such as natural disasters; and
- actual and expected changes in international, national, regional, and local economic and business conditions and developments in which the institution operates that affect the collectability of the loan and lease portfolio.

7. Determine how management estimates credit losses on a group of loans with similar risk characteristics when the institution does not have loss experience of its own for such a loan group.[7]
8. Confirm that loans evaluated individually are not included in a collective assessment of expected credit losses.
9. When the contractual term of a loan or lease extends beyond the reasonable and supportable period, determine whether management reverts to historical loss information, or an appropriate proxy, for those periods beyond the reasonable and supportable forecast period (often referred to as the reversion period).
10. If the ACL for loans and leases includes an *unallocated* amount, determine whether it conforms to GAAP and is properly documented and supported.
11. Where appropriate, determine whether the assessment of an appropriate level for the ACL for loans and leases includes an estimate of losses from transfer risk associated with cross-border lending activities.
12. Determine whether the ACL evaluation process for loans and leases is completed at least quarterly, and evaluate the documentation maintained to support management's assumptions, valuations, and judgments.

LEVEL OF THE ACL

13. Evaluate the level of the ALLL or ACL for loans and leases.
14. Determine whether the ALLL or ACL for loans and leases is appropriate based on a review of the institution's methodology coupled with examination findings as they relate to
    - loan classifications and internal watch list ratings;
    - effectiveness and reliability of the loan review system;
    - level and trend of past due and nonaccrual loans;
    - historical recovery of loan charge-offs;
    - lending policies and procedures, such as underwriting, collection, and charge-off and recovery practices; and
    - changes in the business cycle that necessitate qualitative or environmental factor adjustments to historical loss rates.
15. Consider reviewing applicable ratios as a preliminary check on the reasonableness of the ALLL or ACL for loans and leases.[8]
    - Evaluate trends compared to historical experience (e.g., the relationship of the ALLL or ACL) for loans and leases to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs.
    - Analyze changes in key ratios from prior periods, assess the directional consistency of the ALLL or ACL for loans and leases in relation to these changes, and assess the appropriateness and reasonableness of the ALLL or ACL for loans and leases based on the collectability of the institution's loan portfolio in the current environment.
16. If the institution's loan review system is effective and the methodology for determining an appropriate ALLL or ACL for loans and leases is acceptable, compare the result of the institution's methodology to the actual ALLL or ACL for loans and leases balance. Ensure that the ALLL or ACL amount for loans and leases reported in the institution's regulatory reports and financial statements reconciles to the ALLL or ACL analysis for loans and leases. Assess the reasons for material differences.
17. Assess management's estimated credit losses, and, if necessary, consider the need for additional provision expenses based on examination findings. Consider whether

7. An institution may not have a loss history if the product is new or the institution is a de novo organization.

8. Ratio analysis can be a supplemental check on the reasonableness of management's assumptions and analysis. However, sole use of ratio analysis is insufficient for determining an appropriate level for the ALLL or ACL for loans and leases.

- the loan review system is substantially inaccurate;
- the bank is lending in stressed market conditions;
- credit administration and underwriting weaknesses have not been timely identified or addressed; or
- examination results reflect significant loan quality deterioration.

OVERVIEW

A supplemental interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions[1] was issued by the Federal Financial Institutions Examination Council (FFIEC) on July 2, 2001.[2] The policy statement clarifies the agencies' expectations for documentation that supports the ALLL methodology. Additionally, the statement emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan-review system. The guidance also provides examples of appropriate supporting documentation, as well as illustrations on how to implement this guidance. The policy statement, by its terms, applies only to depository institutions insured by the Federal Deposit Insurance Corporation. Examiners should apply the policy during the examination of state member banks and their subsidiaries. (See SR-01-17.)

The guidance requires that a financial institution's ALLL methodology be in accordance with generally accepted accounting principles (GAAP) and all outstanding supervisory guidance. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated periodically and modified to incorporate new events or findings, as needed. The guidance specifies that management, under the direction of the board of directors, should implement appropriate procedures and controls to ensure compliance with the institution's ALLL policies and procedures. Institution management should (1) segment the portfolio to evaluate credit risks; (2) select loss rates that best reflect the probable loss; and (3) be responsive to changes in the organization, the economy, or the lending environment by changing the methodology, when appropriate. Furthermore, supporting information should be included on summary schedules, whenever feasible. Under this policy, institutions with less complex loan products or portfolios, such as community banks, may use a more streamlined approach to implement this guidance.

The policy statement is consistent with the Federal Reserve's long-standing policy to promote strong internal controls over an institution's ALLL process. In this regard, the new policy statement recognizes that determining an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses.

The policy statement is provided below. Some wording has been slightly modified for this manual, as indicated by asterisks or text enclosed in brackets. Some footnotes have also been renumbered.

2001 POLICY STATEMENT ON ALLL METHODOLOGIES AND DOCUMENTATION

Boards of directors of banks * * * are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.[3] To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and underlying controls, the board of directors should assure themselves that the policies specifically address the institution's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to fol-

1. See 66 *Fed. Reg.* 35629–35639 (July 6, 2001).
2. The guidance was developed in consultation with Securities and Exchange Commission staff, who are issuing parallel guidance in the form of Staff Accounting Bulletin No. 102.
3. The actual policy statement includes a bibliography that lists applicable ALLL GAAP guidance, interagency statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See the appendix for additional information on applying GAAP to determine the ALLL.

low these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the audit committee[4] should oversee and monitor the internal controls over the ALLL-determination process.[5]

The [Federal Reserve and other] banking agencies[6] have long-standing examination policies that call for examiners to review an institution's lending and loan-review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act).[7] The interagency asset-quality guidelines and [this guidance will assist] an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

For financial-reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.[8] This [2001] policy statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.[9]

This guidance [the 2001 policy statement] applies equally to all institutions, regardless of the size. However, institutions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal-approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios. For example, simplified documentation can include spreadsheets, checklists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how less complex institutions may determine and document portions of their loan-loss allowance.

Documentation Standards

Appropriate written supporting documentation for the loan-loss provision and allowance facilitates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL-determination process, and improves

4. All institutions are encouraged to establish audit committees; however, at small institutions without audit committees, the board of directors retains this responsibility.

5. Institutions and their auditors should refer to Statement on Auditing Standards No. 61, "Communication with Audit Committees" (as amended by Statement on Auditing Standards No. 90, "Audit Committee Communications"), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties that have a significant impact on the accounting information included in the financial statements.

6. The [other] banking agencies are the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

7. Institutions should refer to the guidelines for state member banks, appendix D to part 208.

8. The documentation guidance within this [2001] policy statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement No. 5 and No. 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (which includes the *Viewpoints* article—an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); Chapter 7, "Credit Losses," the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions,* 2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

9. Failure to maintain adequate supporting documentation does not relieve an institution of its obligation to record an appropriate ALLL.

the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.[10]

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

- policies and procedures—
  - — over the systems and controls that maintain an appropriate ALLL and
  - — over the ALLL methodology
- loan-grading system or process
- summary or consolidation of the ALLL balance
- validation of the ALLL methodology
- periodic adjustments to the ALLL process

Policies and Procedures

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to—

- the roles and responsibilities of the institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- the institution's accounting policies for loans, [leases, and their loan losses], including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
- the description of the institution's systematic methodology, which should be consistent with the institution's accounting policies for determining its ALLL;[11] and
- the system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal-control system for the ALLL-estimation process should—

- include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- reasonably assure that the institution's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;[12] and
- include a well-defined loan-review process containing—
  - — an effective loan-grading system that is consistently applied, identifies differing risk characteristics and loan-quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
  - — sufficient internal controls to ensure that all relevant loan-review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
  - — clear formal communication and coordination between an institution's credit-administration function, financial-reporting group, management, board of directors, and others who are involved in the ALLL-determination or -review process, as applicable (e.g., written policies and proce-

10. This position is fully described in the SEC's FRR 28, in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.

11. Further explanation is presented in the "Methodology" section that appears below.

12. In addition to the supporting documentation requirements for financial institutions, as described in interagency asset-quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under sections 13(b)(2)–(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality.*

dures, management reports, audit programs, and committee minutes).

Methodology

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan-portfolio characteristics, loan-administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in [the appendix].[13]

Documentation of ALLL Methodology in Written Policies and Procedures

An institution's written policies and procedures should describe the primary elements of the institution's ALLL methodology, including portfolio segmentation and impairment measurement. In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures should describe the methodology—

- for segmenting the portfolio:
  - — how the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
  - — when a loan-grading system is used to segment the portfolio:
    - the definitions of each loan grade,
    - a reconciliation of the internal loan grades to supervisory loan grades, and
    - the delineation of responsibilities for the loan-grading system.
- for determining and measuring impairment under FAS 114:
  - — the methods used to identify loans to be analyzed individually;
  - — for individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including—
    - procedures describing the impairment-measurement techniques available and
    - steps performed to determine which technique is most appropriate in a given situation.
  - — the methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- for determining and measuring impairment under FAS 5—
  - — how loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
  - — how loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
  - — descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan-review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

ALLL Under FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan-review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document—

- the method and process for identifying loans to be evaluated under FAS 114 and
- the analysis that resulted in an impairment decision for each loan and the determination

13. Also, refer to paragraph 7.05 of the AICPA Audit Guide.

of the impairment-measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present-value-of-expected-future-cash-flows method—
  - — the amount and timing of cash flows,
  - — the effective interest rate used to discount the cash flows, and
  - — the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- When using the fair-value-of-collateral method—
  - — how fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
  - — the supporting rationale for adjustments to appraised values, if any,
  - — the determination of costs to sell, if applicable, and
  - — appraisal quality, and the expertise and independence of the appraiser.
- When using the observable-market-price-of-a-loan method—
  - — the amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.[14] [Examples 1 and 2 provide examples of applying and documenting impairment-measurement methods under FAS 114. Some loans that are evauluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Example 3 presents an institution whose loan portfolio includes fully collateralized loans. It describes the documentation maintained by that institution to support its conclusion that no ALLL was needed for those loans.]

14. The [referenced] illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of [numbered examples is provided. These examples were included in appendix A of the policy statement as questions and answers. The wording of the examples has been slightly modified for this format.]

Illustration A

Documenting an ALLL Under FAS 114

Comprehensive worksheet for the impairment-measurement process

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment-measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment-measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Example 1: ALLL Under FAS 114—Measuring and Documenting Impairment

Facts. Approximately one-third of Institution A's commercial loan portfolio consists of large-balance, nonhomogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large-balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

Analysis. For the commercial loans reviewed under FAS 114 that are individually impaired, Institution A should measure and document the impairment on those loans. For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral).

An impairment-measurement method other than the methods allowed by FAS 114 cannot be used. For the loans considered individually impaired under FAS 114, under the circumstances described above, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If it uses the present value of expected future cash flows to measure impairment of a loan, it should document (1) the amount and timing of cash flows, (2) the effective interest rate used to discount the cash flows, and (3) the basis for the determination of cash flows, including consideration of current environmental factors[15] and other information reflecting past events and current conditions. If Institution A uses the fair value of collateral to measure impairment, it should document (1) how it determined the fair value, including the use of appraisals, valuation assumptions and calculations; (2) the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable; (3) appraisal quality; and (4) the expertise and independence of the appraiser. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Example 2: ALLL Under FAS 114—Measuring Impairment for a Collateral-Dependent Loan

Facts. Institution B has a $10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser 18 months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was $12 million.

Institution B believes that certain of the assumptions that were used to value the collateral 18 months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit-review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.[16] After adjusting the collateral-valuation assumptions, the credit-review department determines that the current estimated fair value of the collateral, less costs to sell, is $8 million. Given that the recorded investment in the loan is $10 million, Institution B concludes that the loan is impaired by $2 million and records an allowance for loan losses of $2 million.

Analysis. Institution B should maintain documentation to support its determination of the allowance for loan losses of $2 million for the loan to Company X. It should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be $8 million. This documentation should include (1) the institution's rationale and basis for the $8 million valuation, including the revised valuation assumptions it used; (2) the valuation calculation; and (3) the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of $8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the col-

15. Question 16 in Exhibit D-80A of EITF Topic D-80 and [its] attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

16. When reviewing collateral-dependent loans, Institution B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

lateral value declining from $12 million 18months ago to $8 million in the current period.[17]

Example 3: ALLL Under FAS 114—Fully Collateralized Loans

Facts. Institution C has $10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit-administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully collateralized and therefore does not maintain any ALLL balance for these loans.

Analysis. To adequately support its determination that no allowance is needed for this group of loans, Institution C must maintain the following documentation:

- The management summary of the ALLL must include documentation indicating that, in accordance with the institution's ALLL policy, (1) Institution C has verified the collateral protection on these loans, (2) no probable loss has been incurred, and (3) no ALLL is necessary.
- The documentation in Institution C's loan files must include (1) the two independent market quotes obtained each quarter for each loan's collateral amount, (2) the documents evidencing the perfection of the security interest in the collateral and other relevant supporting documents, and (3) Institution C's ALLL policy, including guidance for determining when a loan is considered "fully collateralized," which would not require an ALLL. Institution C's policy should require the following factors to be considered and fully documented:
  - — volatility of the market value of the collateral
  - — recency and reliability of the appraisal or other valuation
  - — recency of the institution's or third party's inspection of the collateral
  - — historical losses on similar loans
  - — confidence in the institution's lien or security position including appropriate—
    - type of security perfection (e.g., physical possession of collateral or secured filing);
    - filing of security perfection (i.e., correct documents and with the appropriate officials);
    - relationship to other liens; and
    - other factors as appropriate for the loan type.

17. In accordance with the FFIEC's *Federal Register* notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 *Fed. Reg.* 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

ALLL Under FAS 5

Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only small institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product-line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, an institution should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

Illustration B

Documenting Segmenting Practices

Documenting a refinement in a segmentation method

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the institution decided to evaluate loss rates on an individual-product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit-review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include—

- loan trial balances by categories and types of loans,
- management reports about the mix of loans in the portfolio,
- delinquency and nonaccrual reports, and
- a summary presentation of the results of an internal or external loan-grading review.

Reports generated to assess the profitability of a loan-product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans

Based on the segmentation of the loan portfolio, an institution should estimate the FAS 5 portion of its ALLL. For those segments that require an ALLL, [18] the institution should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan-review process and analysis of loan performance. The institution should follow a systematic and consistently applied approach to select the most appropriate loss-measurement methods and support its conclusions and rationale with written documentation. Regardless of the methods used to measure losses, an institution should demonstrate and document that the loss-measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.[19]

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the institution's historical loan-loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of

18. An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending institution.

19. Refer to paragraph 8(b) of FAS 5.

its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.[20] Institutions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, institutions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small institution performs a comprehensive historical loss analysis is provided as the first item in Illustration C.

Before employing a loss-estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, institutions that use loss-estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss-estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, institutions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:[21]

- levels of and trends in delinquencies and impaired loans
- levels of and trends in charge-offs and recoveries
- trends in volume and terms of loans
- effects of any changes in risk-selection and underwriting standards, and other changes in lending policies, procedures, and practices
- experience, ability, and depth of lending management and other relevant staff
- national and local economic trends and conditions
- industry conditions
- effects of changes in credit concentrations

For any adjustment of loss measurements for environmental factors, the institution should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Example 4 provides an example of maintaining sup-

20. Refer to paragraph 23 of FAS 5.

21. Refer to paragraph 7.13 in the AICPA Audit Guide.

Illustration C

Documenting the Setting of Loss Rates

Comprehensive loss analysis in a small institution

A small institution determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss-factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

An institution develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

porting documentation for adjustments to portfolio-segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Example 5 describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

Example 4: ALLL Under FAS 5—Adjusting Loss Rates

Facts. Institution D's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices, and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Institution D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Analysis. Institution D should document its support for the loss-rate adjustments that result from considering these manufacturing firms' financial downturns. It should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, it should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D should maintain copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, economic data, and notes from discussions with individual borrowers.

Since Institution D has had similar situations in the past, its supporting documentation should also include an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, a summary should be created of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Example 5: ALLL Under FAS 5—Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts. Institution E has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt-service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan-grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1, and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.[22]

In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, provides a reasonable estimate of the institution's probable loan losses in these segments.

22. These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

Analysis. Institution E should adequately document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired. As part of its effective ALLL methodology, Institution E documents the decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It should also document the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

Consolidating the Loss Estimates

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include—

- the estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- the aggregate probable loss estimated using the institution's methodology;
- a summary of the current ALLL balance;
- the amount, if any, by which the ALLL is to be adjusted;[23] and
- depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

23. Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration D describes how an institution documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Example 6 addresses the documentation of the final amount of the ALLL.

Illustration D

Summarizing Loss Estimates

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, an institution adds detailed supporting information to its summary schedule. For example, this institution's board of directors receives, within the body of the ALLL summary schedule, a brief description of the institution's policy for selecting loans for evaluation under FAS 114. Additionally, the institution identifies which FAS 114 impairment-measurement method was used for each individually reviewed impaired loan. Other items on the schedule include a brief description of the loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Example 6: Consolidating the Loss Estimates—Documenting the Reported ALLL

Facts. Institution F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the credit committee, and, ultimately, the board of directors. Members of senior management and the credit committee meet to discuss the ALLL. During these discussions, they identify changes that are required by GAAP to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by senior management and the credit committee, as well as a verbal explanation of the changes made by senior management and the credit committee when they met to discuss the loan-loss allowance.

Analysis. Institution F's documentation practices supporting the balance of its loan-loss allowance, as reported in its financial statements, are not in compliance with existing documentation guidance. An institution must maintain supporting documentation for the loan-loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan-loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For institutions subject to external audit, this documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the institution uses.

Validating the ALLL Methodology

An institution's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the institution's methodology should include procedures that adjust loss-estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guid ance, an institution's directors should establish internal-control policies, appropriate for the size of the institution and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL-estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan-grading process. Examples are—

- a review of trends in loan volume, delinquencies, restructurings, and concentrations;
- a review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries;
- a review by a party that is independent of the ALLL-estimation process (this often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates); and
- an evaluation of the appraisal process of the underlying collateral. (This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.)

Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL-review function. Additional documentation often includes the summary findings of the independent reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

Appendix—Application of GAAP

[This appendix was designated appendix B in the policy statement.] An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.[24] A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.[25]

Under GAAP, Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.[26] Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest

24. This appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance-sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Banks and Savings Institutions,* 2000 edition (AICPA Audit Guide). Additionally, this appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a Replacement of FASB Statement No. 125" (FAS 140).

25. Refer to FASB Interpretation No. 14, "Reasonable Estimation of the Amount of a Loss," and Emerging Issues Task Force Topic No. D-80, "Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (EITF Topic D-80).

26. EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other.***

rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The following illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged off.

Illustration

Interaction of FAS 114 with an Adversely Classified Loan, Partial Charge-Off, and the Overall ALLL

An institution determined that a collateral-dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified as "Loss," the portion of the recorded investment deemed to be the confirmed loss and classified the remaining recorded investment as "Substandard." For this loan, the amount classified "Loss" was less than the impairment amount (as determined under FAS 114). The institution charged off the "Loss" portion of the loan. After the charge-off, the portion of the ALLL related to this "Substandard" loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution's overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114.[27] Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired. Institutions should ensure that they do not layer their loan-loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.[28]

While different institutions may use different methods, there are certain common elements that should be included in any loan-loss allowance methodology. Generally, an institution's methodology should—

- include a detailed analysis of the loan portfolio, performed on a regular basis;
- consider all loans (whether on an individual or group basis);
- identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- consider all known relevant internal and external factors that may affect loan collectibility;
- be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- consider the particular risks inherent in different kinds of lending;

27. In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

28. According to the Federal Financial Institutions Examination Council's *Federal Register* notice, Implementation Issues Arising from FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

- consider current collateral values (less costs to sell), where applicable;
- require that analyses, estimates, reviews, and other ALLL methodology functions be performed by competent and well-trained personnel;
- be based on current and reliable data;
- be well documented, in writing, with clear explanations of the supporting analyses and rationale; and
- include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.[29]

29. Refer to paragraph 7.05 of the AICPA Audit Guide.

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.[30]

30. Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

The federal banking agencies[1] issued, in January 2012, "Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1–4 Family Residential Properties." The guidance was issued to address the allowance for loan and lease losses (ALLL) estimation practices for junior-lien loans and lines of credit (collectively, junior liens). (See SR-12-3.)

Domestic banking organizations that are supervised by the Federal Reserve are reminded to consider all credit quality indicators relevant to their junior liens. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien has been modified. Institutions should ensure that during the ALLL estimation process, sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios.

Based on the rapid growth in home equity lending during the 2003–2007 timeframe, a significant volume of home equity lines of credit (HELOCs) will be approaching the end of their draw periods within the next several years and will either convert to amortized loans or will start having principal due as a balloon payment. An institution with a significant number of HELOCs should ensure that its ALLL methodology appropriately captures the elevated borrower default risk associated with any upcoming payment shocks.

This 2012 ALLL guidance applies to institutions of all sizes. The guidance states that an institution should use reasonably available tools to determine the payment status of senior liens associated with its junior liens, such as credit reports, third-party services, or, in certain cases, a proxy. It is expected that large, complex institutions would find most tools reasonably available and would use proxies in limited circumstances.

The guidance does not add or modify existing regulatory reporting requirements issued by the agencies or current generally accepted accounting principles (GAAP). This guidance reiterates key concepts included in GAAP and existing supervisory guidance related to the ALLL. (See, for example, SR-01-17 and SR-06-17 and their attachments. See also sections 2070.1 and 2072.1.)

Institutions also are reminded to follow appropriate risk-management principles in managing junior-lien loans and lines of credit, including the May 2005 "Interagency Credit Risk Management Guidance for Home Equity Lending." (See SR-05-11 and section 2090.1.)

ALLL ESTIMATION PRACTICES FOR LOANS AND LINES OF CREDIT SECURED BY JUNIOR LIENS ON 1–4 FAMILY RESIDENTIAL PROPERTIES

Amidst continued uncertainty in the economy and the housing market, federally regulated financial institutions are reminded to monitor all credit quality indicators relevant to credit portfolios, including junior liens. While the following guidance specifically addresses junior liens, it contains principles that apply to estimating the ALLL for all types of loans. Institutions also are reminded to follow appropriate risk-management principles in managing junior-lien loans and lines of credit, including those in the May 2005 "Interagency Credit Risk Management Guidance for Home Equity Lending."

The December 2006 "Interagency Policy Statement on the Allowance for Loan and Lease Losses" (IPS) states: "Estimates of credit losses should reflect consideration of the significant factors that affect the collectibility of the portfolio as of the evaluation date."

The "Interagency Credit Risk Management Guidance for Home Equity Lending" states: "Financial institutions should establish an appropriate ALLL and hold capital commensurate with the riskiness of portfolios. In determining the ALLL adequacy, an institution should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for the HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy."

1. The federal banking agencies are the Board of Governors of the Federal Reserve System (Federal Reserve Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA).

While the 2012 ALLL guidance specifically addresses junior liens, it contains principles that apply to estimating the ALLL for *all types* of loans.

Responsibilities of Management

Consideration of All Significant Factors

Institutions should ensure that during the ALLL estimation process sufficient information is gathered to adequately assess the probable loss incurred within junior-lien portfolios. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien loan has been modified. Institutions with significant holdings of junior liens should gather and analyze data on the associated senior-lien loans it owns or services. When an institution does not own or service the associated senior-lien loans, it should use reasonably available tools to determine the payment status of the senior-lien loans. Such tools include obtaining credit reports or data from third-party services to assist in matching an institution's junior liens with its associated senior liens. Additionally, an institution may, as a proxy, use the relevant performance data on similar senior liens it owns or services. An institution with an insignificant volume of junior-lien loans and lines of credit may use judgment when determining what information about associated senior liens not owned or serviced is reasonably available.

Institutions with significant holdings of junior liens should also periodically refresh other credit quality indicators the organization has deemed relevant about the collectibility of its junior liens, such as borrower credit scores and combined loan-to-value ratios (CLTVs), which include both the senior and junior liens. An institution should refresh relevant credit quality indicators as often as necessary considering economic and housing market conditions that affect the institution's junior-lien portfolio. As noted in SR-06-17, "changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses." For example, if declining credit quality trends in the factors relevant to either junior liens or their associated senior-lien loans are evident, the ALLL level as a percentage of the junior-lien portfolio should generally increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the junior-lien portfolio should generally decrease.

Institutions routinely gather information for credit-risk management purposes, but some may not fully use that information in the allowance estimation process. Institutions should consider all reasonably available and relevant information in the allowance estimation process, including information obtained for credit-risk management purposes. Financial Accounting Standards Board Accounting Standards Codification (ASC) Topic 450 states that losses should be accrued by a charge to income if information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired. The 2006 IPS states, "...estimates of credit losses should reflect consideration of all significant factors." (See SR-06-17 and its attachment.) Consequently, it is considered inconsistent with both GAAP and supervisory guidance to fail to gather and consider reasonably available and relevant information that would significantly affect management's judgment about the collectibility of the portfolio.[2]

Adequate Segmentation

Institutions normally segment their loan portfolio into groups of loans based on risk characteristics as part of the ALLL estimation process. Institutions with significant holdings of junior liens should ensure adequate segmentation within their junior-lien portfolio to appropriately estimate the allowance for high-risk segments within this portfolio. A lack of segmentation can result in an allowance established for the entire junior-lien portfolio that is lower than what the allowance would be if high-risk loans were segregated and grouped together for evaluation in one or more separate segments. The following credit quality indicators may be appropriate for use in identifying high-risk junior-lien portfolio segments:

2. "Portfolio" refers to loans collectively evaluated for impairment under ASC Topic 450; this supervisory guidance may also be applicable to junior-lien loans that are subject to measurement for impairment under ASC Subtopic 310-10, Receivables - Overall (formerly Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*) and ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*).

- delinquency and modification status of an institution's junior liens
- delinquency and modification status of senior-lien loans associated with an institution's junior liens
- current borrower credit score
- current CLTV
- origination channel
- documentation type
- property type (for example, investor owned or owner-occupied)
- geographic location of property
- origination vintage
- HELOCs where the borrower is making only the minimum payment due
- HELOCs where current information and conditions indicate that the borrower will be subject to payment shock

In particular, institutions should ensure their ALLL methodology adequately incorporates the elevated borrower default risk associated with payment shocks due to (1) rising interest rates for adjustable rate junior liens, including HELOCs,[3] or (2) HELOCs converting from interest-only to amortizing loans. If the default rate of junior liens that have experienced payment shock is higher than the default rate of junior liens that have not experienced payment shock, an institution should determine whether it has a significant number of junior liens approaching their conversion to amortizing loans or approaching an interest rate adjustment date. If so, to ensure the institution's estimate of credit losses is not understated, it would be necessary to adjust historical default rates on these junior liens to incorporate the effect of payment shocks that, based on current information and conditions, are likely to occur.

Adequate segmentation of the junior-lien portfolio by risk factors should facilitate an institution's ability to track default rates and loss severity for high-risk segments and its ability to appropriately incorporate these data into the allowance estimation process.

3. Forecasts of future interest rate increases should not be included in the determination of the ALLL. However, if rates have risen since the last rate adjustment, the effect of the increase on the amount of the payment at the next rate adjustment should be considered.

Qualitative or Environmental Factor Adjustments

As noted in SR-06-17, institutions should adjust a loan group's historical loss rate for the effect of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the ASC Subtopic 450-20 component of the ALLL.

When an institution uses qualitative or environmental factors to estimate probable losses related to individual high-risk segments within the junior-lien portfolio, any adjustment to the historical loss rate or any separate standalone adjustment should be supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments. In addition, changes in the allowance allocation for junior liens should be directionally consistent with changes in the factors taken as a whole that evidence credit losses on junior liens, keeping in mind the characteristics of the institution's junior-lien portfolio.

Charge-Off and Nonaccrual Policies

Banking institutions should ensure that their charge-off policy on junior liens is in accordance with the June 2000 Uniform Retail Credit Classification and Account Management Policy. (See SR-00-8 and the appendix of section 2130.1.) As stated in SR-06-17, "when available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL."

Institutions also should ensure that income-recognition practices related to junior liens are appropriate. Consistent with GAAP and regulatory guidance, institutions are expected to have revenue recognition practices that do not result in overstating income. Placing a junior lien on nonaccrual, including a current junior lien, when payment of principal or interest in full is not expected is one appropriate method to ensure that income is not overstated. An institution's income-recognition policy should incorporate management's consideration of all reasonably available information including, for junior liens, the performance of the associated senior liens as well as trends in other credit quality indicators. The policy should require that consideration of these factors takes place before foreclosure on the senior lien or delinquency of the junior lien. The policy should also explain how management's consideration of these factors affects income recognition prior to foreclosure on the senior lien or delinquency of the junior lien to ensure income is not overstated.

Responsibilities of Examiners

To the extent an institution has significant holdings of junior liens, examiners should assess the appropriateness of the institution's ALLL methodology and documentation related to these loans, and the appropriateness of the level of the ALLL established for this portfolio. As noted in SR-06-17, for analytical purposes, an institution should attribute portions of the ALLL to loans that it individually evaluates and determines to be impaired under ASC Subtopic 310-10 and to groups of loans that it evaluates collectively under ASC Subtopic 450-20. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

Consistent with SR-06-17, in their review of the junior-lien portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio. Examiners should take the following steps when reviewing the appropriateness of an institution's allowance that is established for junior liens:

- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL for junior liens. This should include whether all significant qualitative or environmental factors that affect the collectibility of the portfolio (including those factors previously discussed) have been appropriately considered in accordance with GAAP.
- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review management's support for any qualitative or environmental factor adjustments to the allowance related to junior liens. Examiners should ensure that all relevant qualitative or environmental factors were considered and adjustments to historical loss rates for specific risk segments within the junior-lien portfolio are supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments.
- Review the interest income accounts associated with junior liens to ensure that the institution's net income is not overstated.

If the examiner concludes that the reported ALLL for junior liens is not appropriate or determines that the ALLL evaluation process is deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. Examiners should cite any departures from GAAP and regulatory guidance, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process.

ALLL Estimation Practices for Loans Secured by Junior Liens
Examination Objectives
Effective date April 2012

Section 2015.2

The examination objectives for an institution that has significant holdings of loans secured by junior liens are as follows:

1. To evaluate the appropriateness of the institution's methodology and documentation of the allowance for loan and lease losses (ALLL) related to these loans.
2. To ascertain whether the institution's policies, practices, procedures, and internal controls regarding the ALLL estimation practices for loans secured by junior liens are sufficient.
3. To determine whether the level of the ALLL is reasonable and adequate for the institution's volume of such loans outstanding.
4. To evaluate if the institution has fully considered and accounted for all significant qualitative or environmental factors that affect the collectability of such loans.
5. To ascertain whether the portfolio has been properly accounted in accordance with generally accepted accounting principles and whether all applicable supervisory and regulatory guidance, as well as statutory and regulatory requirements, have been adhered to.

1. To the extent an institution has significant holdings of loans secured by junior liens, assess the appropriateness of the institution's
   a. allowance for loan and lease loss (ALLL) methodology and documentation related to these loans, and
   b. ALLL level established for this portfolio.
2. During the examination's review of the of the junior-lien portfolio, consider all significant qualitative or environmental factors that affect the collectibility of the junior-lien portfolio and whether they have been appropriately considered in accordance with generally accepted accounting principles (GAAP).
3. Perform the following steps when reviewing the appropriateness of the institution's ALLL that is established for junior liens:
   a. Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL for junior liens.
   b. Review management's use of loss-estimation models or other loss-estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
   c. Review management's support for any qualitative or environmental factor adjustments to the ALLL related to junior liens. Ensure that all relevant qualitative or environmental factors were considered and adjustments to historical loss rates for specific risk segments within the junior-lien portfolio are supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments.
   d. Review the interest income accounts associated with junior liens to ensure that the institution's net income is not overstated.
4. Provide comments in the examination report when the ALLL for junior liens is not appropriate or if the ALLL evaluation process is deficient. Include recommendations for correcting these deficiencies and any concerns regarding an appropriate level for the ALLL.
5. Cite in the examination report any departures from GAAP and regulatory guidance, as applicable.

This section sets forth the June 29, 2011, ''Interagency Supervisory Guidance of Counterparty Credit Risk Management'' issued by the federal banking agencies.[1] The guidance discusses the critical aspects of effective management of counterparty credit risk (CCR), and it sets forth sound practices and supervisory expectations for the development of an effective CCR-management framework. CCR is the risk that the counterparty to a transaction could default or deteriorate in creditworthiness before the final settlement of a transaction's cash flows. Unlike the credit risk for a loan, when only the lending banking organization faces the risk of loss, CCR creates a bilateral risk of loss because the market value of a transaction can be positive or negative to either counterparty. The future market value of the exposure and the counterparty's credit quality are uncertain and may vary over time as underlying market factors change.

This CCR guidance is intended for use by banking organizations,[2] especially those with large derivatives portfolios, in setting their risk-management practices as well as by supervisors as they assess and examine such institutions' management of CCR. For other banking organizations without large derivatives portfolios, risk managers and supervisors should apply this guidance as appropriate, given the size, nature, and complexity of the CCR risk profile of the banking organization, although this guidance would generally not apply to community banking organizations.

CCR is a multidimensional form of risk, affected by both the exposure to a counterparty and the credit quality of the counterparty, both of which are sensitive to market-induced changes. It is also affected by the interaction of these risks—for example, the correlation[3] between an exposure and the credit spread of the counterparty, or the correlation of exposures among the banking organization's counterparties. Constructing an effective CCR-management framework requires a combination of risk-management techniques from the credit-, market-, and operational-risk disciplines.

This guidance reinforces sound governance of CCR-management practices, through prudent board and senior management oversight, management reporting, and risk-management functions. The guidance also elaborates on the sound practices for an effective CCR-management framework and associated characteristics of adequate systems infrastructure. It also covers risk-control functions, such as counterparty limits, margin practices, validating and backtesting models and systems, managing close-outs,[4] managing central counterparty exposures, and controlling legal and operational risks arising from derivatives activities.

CCR-management guidelines and supervisory expectations are delineated in various individual and interagency policy statements and guidance,[5] which remain relevant and applicable. This guidance offers further explanation and clarification, particularly in light of developments in CCR management. However, this guidance is not all-inclusive, and banking organizations should reference sound practices for CCR management, such as those advanced by industry, policymaking, and supervisory forums.[6] (See SR 11-10.)

1. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC). The former Office of Thrift Supervision (OTS) also participated in developing this guidance.

2. For the purposes of this CCR guidance, unless otherwise indicated, the term *banking organizations* is intended to refer to state member banks, state nonmember banks, national banks, federal savings associations, state-chartered savings associations, bank holding companies, and savings and loan holding companies. The U.S. branches and agencies of foreign banks are also considered to be banking organizations for purposes of this guidance.

3. In this guidance, ''correlation'' refers to any form of linear or nonlinear interrelationship or dependence between factors.

4. A close-out is the process undertaken by a banking organization following default of a counterparty to fully collect on all items due from that counterparty.

5. See, for example, the FFIEC ''Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities,'' 63 *Fed. Reg.* 20191, April 23, 1998. Federal Reserve examination guidance on CCR is contained in SR-99-3, section 2126.3 of the *Bank Holding Company Supervision Manual* and section 2020.1 of the *Trading and Capital-Markets Activities Manual.*

6. Industry, policymaking, and supervisory groups include, but are not limited to, the Counterparty Risk Management Policy Group (CRMPG), Committee on Payment and Settlement Systems (CPSS), International Swaps and Derivatives Association (ISDA), Institute of International Finance (IIF), Group of Thirty (G30), Group of Twenty Finance Ministers and Central Bank Governors (G-20), International Organization of Securities Commissions (IOSCO), Senior Supervisors Group (SSG), and Basel Committee on Banking Supervision (BCBS). Documents produced by all of these groups were drawn upon in developing this guidance.

GOVERNANCE

Board and Senior Management Responsibilities

The board of directors or a designated board-level committee (board) should clearly articulate the banking organization's risk tolerance for CCR by approving relevant policies, including a framework for establishing limits on individual counterparty exposures and concentrations of exposures. Senior management should establish and implement a comprehensive risk-measurement and management framework consistent with this risk tolerance that provides for the ongoing monitoring, reporting, and control of CCR exposures.

Senior management should adhere to the board's established risk tolerance and should establish policies and risk-management guidelines appropriately. At a minimum, policies should outline CCR-management standards that are in conformance with this guidance. More specifically, they should address the subjects discussed in this document, such as risk measurement and reporting, risk-management tools, and processes to manage legal and operational risk. Policies should be detailed and contain a clear escalation process for review and approval of policy exceptions, especially those pertaining to transaction terms and limits.

Management Reporting

Banking organizations should report counterparty exposures to the board and senior management at a frequency commensurate with the materiality of exposures and the complexity of transactions. Reporting should include concentration analysis and CCR stress-testing results to allow for an understanding of exposures and potential losses under severe market conditions. Reports should also include an explanation of any measurement weaknesses or limitations that may influence the accuracy and reliability of the CCR risk measures.

Senior management should have access to timely, accurate, and comprehensive CCR reporting metrics, including an assessment of significant issues related to the risk-management aspects discussed in this guidance. They should review CCR reports at least monthly, with data that are no more than three weeks old. It is general practice for institutions to report the following:

- total counterparty credit risk aggregated on a firm-wide basis and at significant legal entities
- counterparties with the largest exposures, along with detail on their exposure amounts
- exposures to central counterparties (CCPs)
- significant concentrations, as outlined in this guidance
- exposures to weak or problem counterparties
- growth in exposures over time; as a sound practice, metrics should capture quarterly or monthly changes, supplemented (where relevant) by year-over-year trend data
- exposures from over-the-counter (OTC) derivatives; when they are material, additional product-class breakouts (for example, traditional lending, securities lending) should be included
- a sufficiently comprehensive range of CCR metrics, as discussed in the CCR metrics section
- a qualitative discussion of key risk drivers of exposures or conditions or factors that would fundamentally change the risk profile of CCR; an example would be assessment of changes in credit underwriting terms and whether they remain prudent

Risk-Management Function and Internal Audit

Risk Management

A banking organization's board and senior management should clearly delineate the respective roles of business lines versus risk management, both in terms of initiating transactions that have CCR and of ongoing CCR management. The board and senior management should ensure that the risk-management functions have adequate resources, are fully independent from CCR-related trading operations (in both activity and reporting), and have sufficient authority to enforce policies and to escalate issues to senior management and the board (independent of the business line).

Internal Audit

The board should direct internal audit to regularly assess the adequacy of the CCR-management framework as part of the regular audit plan. Such assessments should include credit-line approval processes, credit ratings, and credit monitoring. Such an assessment should opine on the adequacy of the CCR infrastructure and processes, drawing where appropriate from individual business line reviews or other internal and external audit work. (See the relevant section of this guidance regarding the role of CCR model validation or review.) The board should review annual reports from internal audit and model validation or review, assessing the findings and confirming that management has taken appropriate corrective actions.

RISK MEASUREMENT

CCR Metrics

Given the complexity of CCR exposures (particularly regarding OTC derivatives), banking organizations should employ a range of risk-measurement metrics to promote a comprehensive understanding of CCR and how it changes in varying environments. Metrics should be commensurate with the size, complexity, liquidity, and risk profile of the CCR portfolio. Banking organizations typically rely on certain metrics as a primary means of monitoring, with secondary metrics used to create a more robust view of CCR exposures. Banking organizations should apply these metrics to single counterparty exposures, groups of counterparties (for example, by internal rating, industry, geographical region), and the consolidated CCR portfolio. Banking organizations should assess their largest exposures, for instance their top 20 exposures, using each primary metric.

Major dealers and large, sophisticated banking organizations with substantial CCR exposure should measure and assess

- current exposure (both gross and net of collateral);
- forward-looking exposure (that is, potential exposure);
- stressed exposure (broken out by market-risk factors and/or by scenario);
- aggregate and stressed credit valuation adjustment (CVA) as well as CVA factor sensitivities;
- additional relevant risk measures, such as (for credit derivatives) jump-to-default risk on the reference obligor, and economic capital usage;
- the largest exposures by individual business line and product types; and
- correlation risks, such as wrong-way risk, as well as the credit quality of collateral.

Refer to this section's Appendix A for definitions of basic metrics and descriptions of their purposes.

Aggregation of Exposures

Banking organizations should have the capacity to measure their exposure at various levels of aggregation (for example, by business line, legal entity, or consolidated by industry). Systems should be sufficiently flexible to allow for timely aggregation of all CCR exposures (that is, OTC derivatives, securities financing transactions (SFTs), and other presettlement exposures), as well as aggregation of other forms of credit risk to the same counterparty (for example, loans, bonds, and other credit risks). The following are sound CCR-aggregation principles:

- Counterparty-level current exposure and potential exposure should be calculated daily, based on the previous day's position data and any exchange of collateral.
- For each organizational level of aggregation, all trades should be included.
- There should be sufficient flexibility to aggregate exposure at varying levels of granularity, including industries, regions, families of products (for example, OTC derivatives, SFTs), or other groupings to identify concentrations.
- While banking organizations are not required to express all forms of risk in a common metric or basis, management should be able to view the various forms of exposures to a given counterparty in a single report and/or system. Specifically, this could include current outstanding exposure across different categories (e.g., current exposure for OTC derivatives and drawn-down lines of commitment for loans). Exposure reports should also include the size of settlement and clearing lines.
- Banking organizations should be consistent in their choice of currency and exchange rate, and take into account the validity and legal enforceability of any netting agreements they may have with a counterparty.
- Management should understand the specific approach used to aggregate exposures for any given risk measure, in order to properly assess

the results. For instance, some measures of risk (such as current exposure) may be readily added together, while others (such as potential exposure) are less meaningful when they are added to form an aggregate view of risk.
- Internal capital adequacy models should incorporate CCR.

Concentrations

Concentrated exposures are a significant concern, as CCR can contribute to sudden increases in credit exposure, which in turn can result in unexpectedly large losses in the event of counterparty default. Accordingly, banking organizations should have enterprise-wide processes to effectively identify, measure, monitor, and control concentrated exposures on both a legal entity and enterprise-wide basis.

Concentrations should be identified using both quantitative and qualitative means. An exposure or group of related exposures (for example, firms in the same industry), should be considered a concentration in the following circumstances: exposures (individually or collectively) exceed risk-tolerance levels established to ensure appropriate diversification; deterioration of the exposure could result in material loss; or deterioration could result in circumstances that are detrimental to the banking organization's reputation. All credit exposures should be considered as part of concentration management, including loans, OTC derivatives, names in bespoke and index CDO credit tranches, securities settlements, and money market transactions such as fed funds sold. Total credit exposures should include the size of settlement and clearing lines or other committed lines.

CCR-concentration management should identify, quantify, and monitor the following:

- Individual counterparties with large potential exposures, when those exposures are driven by a single market factor or transaction type. In these circumstances, banking organizations should supplement statistical measures of potential exposure with other measures, such as stress tests, that identify such concentrations and provide an alternative view of risks associated with close-outs.
- Concentrations of exposures to individual legal entities, as well as concentrations across affiliated legal entities at the parent entity level, or in the aggregate for all related entities.
- Concentrations of exposures to industries or other obligor groupings.
- Concentrations of exposures to geographic regions or country-specific groupings sensitive to similar macroeconomic shocks.
- Concentrations across counterparties when potential exposure is driven by the same or similar risk factors. For both derivatives and SFTs, banking organizations should understand the risks associated with crowded trades,[7] where close-out risk may be heightened under stressed market conditions.
- Collateral concentrations, including both risk concentrations with a single counterparty and risks associated with portfolios of counterparties. Banking organizations should consider concentrations of noncash collateral for all product lines covered by collateral agreements,[8] including collateral that covers a single counterparty exposure and portfolios of counterparties.[9]
- Collateral concentrations involving special purpose entities (SPEs). Collateral-concentration risk is particularly important for SPEs, because the collateral typically represents an SPE's paying capacity.
- Banking organizations should consider the full range of credit risks in combination with CCR to manage concentration risk, including risks from on- and off-balance-sheet activities, contractual and noncontractual risks, contingent and noncontingent risks, as well as underwriting and pipeline risks.

Stress Testing

Banking organizations with significant CCR exposures should maintain a comprehensive stress-testing framework, which is integrated into the banking organization's CCR manage-

7. For purposes of this guidance, a "crowded trade" is a large balance of open trading positions in a given asset or group of assets relative to its daily trading volume, when other market participants have similar positions that would need to be liquidated should any adverse price change occur. Coincident sale of these assets by a large number of market participants could lead to significant price declines and dramatic increases in uncollateralized exposures.

8. Banking organizations should also track concentrations in volatile currencies.

9. This analysis is particularly important with repo-style transactions and other forms of SFTs for which the ability of market participants to liquidate large collateral positions may be difficult during periods of market turbulence.

ment. The framework should inform the banking organization's day-to-day exposure and concentration management, and it should identify extreme market conditions that could excessively strain the financial resources of the banking organization. Regularly, but no less than quarterly, senior management should evaluate stress-test results for evidence of potentially excessive risk and take risk-reduction strategies as appropriate.

The severity of factor shocks should be consistent with the purpose of the stress test. When evaluating solvency under stress, factor shocks should be severe enough to capture historical extreme market environments and/or extreme-but-plausible stressed market conditions. The impact of such shocks on capital resources and earnings should be evaluated. For day-to-day portfolio monitoring, hedging, and management of concentrations, banking organizations should also consider scenarios of lesser severity and higher probability. When conducting stress testing, risk managers should challenge the strength of assumptions made about the legal enforceability of netting and the ability to collect and liquidate collateral.

A sound stress-testing framework should include the following:

- Measurement of the largest counterparty-level impacts across portfolios, material concentrations within segments of a portfolio (such as industries or regions), and relevant portfolio- and counterparty-specific trends.
- Complete trade capture and exposure aggregation across all forms of trading (not just OTC derivatives) at the counterparty-specific level, including transactions that fall outside of the main credit system. The time frame selected for trade capture should be commensurate with the frequency with which stress tests are conducted.
- Stress tests, at least quarterly, of principal market-risk factors on an individual basis (for example, interest rates, foreign exchange, equities, credit spreads, and commodity prices) for all material counterparties. Banking organizations should be aware that some counterparties may be material on a consolidated basis, even though they may not be material on an individual legal-entity basis.
- Assessment of nondirectional risks (for example, yield-curve exposures and basis risks) from multifactor stress-testing scenarios. Multifactor stress tests should, at a minimum, aim to address separate scenarios: severe economic or market events; significant decrease in broad market liquidity; and the liquidation of a large financial intermediary of the banking organization, factoring in direct and indirect consequences.
- Consideration, at least quarterly, of stressed exposures resulting from the joint movement of exposures and related counterparty creditworthiness. This should be done at the counterparty-specific and counterparty-group (for example, industry and region) level, and in aggregate for the banking organization. When CVA methodologies are used, banking organizations should ensure that stress testing sufficiently captures additional losses from potential defaults.[10]
- Basic stress testing of CVA to assess performance under adverse scenarios, incorporating any hedging mismatches.
- Concurrent stress testing of exposure and noncash collateral for assessing wrong-way risk.
- Identification and assessment of exposure levels for certain counterparties (for example, sovereigns and municipalities), above which the banking organization may be concerned about willingness to pay.
- Integration of CCR stress tests into firm-wide stress tests.[11]

Credit Valuation Adjustments

CVA refers to adjustments to transaction valuation to reflect the counterparty's credit quality. CVA is the fair-value adjustment to reflect CCR in valuation of derivatives. As such, CVA is the market value of CCR and provides a market-based framework for understanding and valuing the counterparty credit risk embedded in derivative contracts. CVA may include only the adjustment to reflect the counterparty's credit quality (a one-sided CVA or just CVA), or it may include an adjustment to reflect the banking organization's own credit quality. The latter is a two-sided CVA, or CVA plus a debt valuation adjustment (DVA). For the evaluation of the

10. Exposure testing should include single-factor, multifactor, and material nondirectional risks.

11. CCR stress testing should be consistent with overall banking-organization-wide stress testing and follow the principles set forth in the "Principles for Sound Stress Testing Practices and Supervision" issued by the Risk Management and Modeling Group of the Basel Committee in May 2009.

credit risk due to probability of default of counterparties, a one-sided CVA is typically used. For the evaluation of the value of derivatives transactions with a counterparty or the market risk of derivatives transactions, a two-sided CVA should be used.

Although CVA is not a new concept, its importance has grown, partly because of a change in accounting rules that requires banking organizations to recognize the earnings impact of changes in CVA.[12] During the 2007–2009 financial crisis, a large portion of CCR losses were because of CVA losses rather than actual counterparty defaults.[13] As such, CVA has become more important in risk management, as a mechanism to value, manage, and make appropriate hedging decisions, to mitigate banking organizations' exposure to the mark-to-market (MTM) impact of CCR.[14] The following are general standards for CVA measurement and use of CVA for risk-management purposes:

- CVA calculations should include all products and counterparties, including margined counterparties.
- The method for incorporating counterparty credit quality into CVA should be reasonable and subject to ongoing evaluation. CVA should reflect the fair value of the counterparty credit risk for OTC derivatives, and inputs should be based on current market prices when possible.
  - — Credit spreads should be reflected in the calculation where available, and banking organizations should not overly rely on non-market-based probability of default estimates when calculating CVA.
  - — Banking organizations should attempt to map credit quality to name-specific spreads rather than spreads associated with broad credit categories.
  - — Any proxy spreads should reasonably capture the idiosyncratic nature of the counterparty and the liquidity profile.
  - — The term structure of credit spreads should be reflected in the CVA calculation.
- The CVA calculation should incorporate counterparty-specific master netting agreements and margin terms; for example, the CVA calculation should reflect margin thresholds or minimum transfer amounts stated in legal documents.
- Banking organizations should identify the correlation between a counterparty's creditworthiness and its exposure to the counterparty, and seek to incorporate the correlation into their respective CVA calculation.

Management of CVA

CVA management should be consistent with sound risk-management practices for other material MTM risks. These practices should include the following:

- Business units engaged in trades related to CVA management should have independent risk-management functions overseeing their activities.
- Systems that produce CVA risk metrics should be subject to the same controls as used for other MTM risks, including independent validation or review of all risk models, including alternative methodologies.[15]
- Upon transaction execution, CVA costs should be allocated to the business unit that originates the transaction.
  - — As a sound practice, the risk of CVA should be incorporated into the risk-adjusted return calculation of a given business.
  - — CVA cost allocation provides incentive for certain parties to make prudent risk-taking decisions and motivates risk-takers to support risk mitigation, such as requiring strong collateral terms.
- Banking organizations should measure sensitivities to changes in credit- and market-risk factors to determine the material drivers of MTM changes. On a regular basis, but no less frequently than quarterly, banking organizations should ensure that CVA MTM changes

12. See the Financial Accounting Standards Board's accounting literature pertinent to CVA in Accounting Standards Codification (ASC) Topic 820 (formerly FAS Statement 157). In addition, other transaction fair-value adjustments should be conducted—for example, those involving a banking organization's own credit risk or differences in funding costs based on whether transactions are collateralized or not.

13. Basel Committee on Banking Supervision, "Strengthening the Resilience of the Banking Sector—-Consultative Document," December 2009.

14. An accurate measure of CVA is critical to prudent risk-taking, as part of effectively understanding the risk-reward tradeoff in a given derivatives transaction. The more comprehensively CVA is measured, the more transparent the economics of a given transaction.

15. Liquidity in credit markets has varied significantly over time. As liquidity conditions change, banking organizations should calculate CVA using methodologies appropriate to the market pricing information available for each counterparty and transaction type.

are sufficiently explained by these risk factors (for example, through profit and loss attribution for sensitivities and backtesting for value at risk (VaR)).
- Banking organizations hedging CVA MTM should gauge the effectiveness of hedges through measurements of basis risk or other types of mismatches. In this regard, it is particularly important to capture nonlinearities, such as the correlation between market and credit risk, and other residual risks that may not be fully offset by hedging.

CVA VaR

Banking organizations with material CVA should measure the risk of associated loss on an ongoing basis. In addition to stress tests of the CVA, banking organizations may develop VaR models that include CVA to measure potential losses. While these models are currently in the early stages of development, they may prove to be effective tools for risk-management purposes. An advantage of CVA VaR over more traditional CCR risk measures is that it captures the variability of the CCR exposure, the variability of the counterparty's credit spread, and the dependency between them.

Developing VaR models for CVA is significantly more complicated than developing VaR models for a banking organization's market-risk positions. In developing a CVA VaR model, a banking organization should match the percentile and time horizon for the VaR model to those appropriate for the management of this risk, and include all significant risks associated with changes in the CVA. For example, banking organizations may use the same percentile for CVA VaR as they use for market-risk VaR (for example, the 95th or 99th percentile). However, the time horizon for CVA VaR may need to be longer than for market risk (for example, one quarter or one year) because of the potentially illiquid nature of CVA. The following are important considerations in developing a CVA VaR model:

- All material counterparties covered by CVA valuation should be included in the VaR model.
- A CVA VaR calculation that keeps the exposure or the counterparty probability of default static is not adequate. It will not only omit the dependence between the two variables, but also the risk arising from the uncertainty of the fixed variable.
- CVA VaR should incorporate all forms of CVA hedging. Banking organizations and examiners should assess the ability of the VaR measure to accurately capture the types of hedging used by the banking organization.

Wrong-Way Risk

Wrong-way risk occurs when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself. Specific wrong-way risk arises when the exposure to a particular counterparty is positively correlated with the probability of default of the counterparty itself because of the nature of the transactions with the counterparty. General wrong-way risk arises when the probability of default of counterparties is positively correlated with general market-risk factors. Wrong-way risk is an important aspect of CCR that has caused major losses at banking organizations. Accordingly, a banking organization should have a process to systematically identify, quantify, and control both specific and general wrong-way risk across its OTC derivative and SFT portfolios.[16] To prudently manage wrong-way risk, banking organizations should

- maintain policies that formally articulate tolerance limits for both specific and general wrong-way risk, an ongoing wrong-way risk identification process, and the requirements for escalation of wrong-way risk analysis to senior management;
- maintain policies for identifying, approving, and otherwise managing situations when there is a legal connection between the counterparty and the underlying exposure or the associated collateral[17] (banking organizations should generally avoid such transactions because of their increased risk);

16. A standard way of quantifying general wrong-way risk is to design and apply stress scenarios that detect wrong-way risk in the portfolio, record counterparty exposures most affected by the scenarios, and assess whether the creditworthiness of such counterparties is also negatively affected by the scenario.

17. Examples of this situation are single-name credit derivatives when there is a legal relationship between the counterparty and the reference entity underlying the transaction, and financing transactions when the counterparty pledges an affiliate's security as collateral.

- perform wrong-way risk analysis for OTC derivatives, at least at the industry and regional levels; and
- conduct wrong-way risk analysis for SFTs on broad asset classes of securities (for example, government bonds, and corporate bonds).

SYSTEMS INFRASTRUCTURE CONSIDERATIONS

Banking organizations should ensure that systems infrastructure keeps up with changes in the size and complexity of their CCR exposures, and the OTC derivatives market in general. Systems should capture and measure the risk of transactions that may be subject to CCR as a fundamental part of the CCR-management framework.

Banking organizations should have strong operational processes across all derivatives markets, consistent with supervisory and industry recommendations.[18] Management should strive for a single comprehensive CCR-exposure measurement platform.[19] If not currently possible, banking organizations should minimize the number of system platforms and methodologies, as well as manual adjustments to exposure calculations. When using multiple exposure measurement systems, management should ensure that transactions whose future values are measured by different systems are aggregated conservatively.

To maintain a systems infrastructure that supports adequate CCR management, banking organizations should take the following actions:

Data Integrity and Reconciliation

- Deploy adequate operational resources to support reconciliations and related analytical and remediation processes.
- Reconcile positions and valuations with counterparties.
  - — Large counterparties should perform frequent reconciliations of positions and valuations (daily if appropriate).[20]
  - — For smaller portfolios with nondealer counterparties where there are infrequent trades, large dealers should ensure the data integrity of trade and collateral information on a regular (but not necessarily daily) basis, reconciling their portfolios according to prevailing industry standards.
- Reconcile exposure data in CCR systems with the official books and records of the financial institution.
- Maintain controls around obligor names at the point of trade entry, as well as reviews of warehoused credit data, to ensure that all exposures to an obligor are captured under the proper name and can be aggregated accordingly.
- Maintain quality control over transfer of transaction information between trade capture systems and exposure measurement systems.
- Harmonize netting and collateral data across systems to ensure accurate collateral calls and reflection of collateral in all internal systems. Banking organizations should maintain a robust reconciliation process to ensure that internal systems have terms that are consistent with those formally documented in agreements and credit files.
- Remediate promptly any systems weaknesses that raise questions about the appropriateness of the limits structure. If there are a significant number of limit excesses, this may be a symptom of system weaknesses, which should be identified and promptly remediated.
- Eliminate or minimize backlogs of unconfirmed trades.

Automation and Tracking

- Automate legal and operational information, such as netting and collateral terms. Banking organizations should be able to adjust exposure measurements, taking into account the enforceability of legal agreements.
- Automate processes to track and manage legal documentation, especially when there is a large volume of legal agreements.

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18. Examples are recommendations made by the Senior Supervisors Group (a group comprised of senior financial supervisors from ten countries) and the Counterparty Risk Management Policy Group (a group that consists of major, internationally active commercial and investment banks, which works to promote enhanced practices in counterparty credit and market-risk management).

19. A single platform may, in practice, contain a number of separate systems and models. These would be considered a cohesive framework if they are operationally stable and accurate in risk estimation, particularly with regard to proper reflection of collateral and netting. A common programming language for these systems facilitates an effective measurement framework.

20. Large dealer counterparties should perform portfolio reconciliation on a daily basis, as set forth in relevant industry standards, such as the ISDA's "Collateralised Portfolio Reconciliation Best Operational Practices" (January 2010).

- Increase automation of margin processes[21] and continue efforts to expand automation of OTC derivatives post-trade processing. This should include automation of trade confirmations to reduce the lag between trade execution and legal execution.
- Maintain systems that track and monitor changes in credit terms and have triggers for relevant factors, such as net asset value, credit rating, and cross-default.
- Maintain default monitoring processes and systems.

Add-Ons

For large derivatives market participants, certain trades may be difficult to capture in exposure-measurement systems, and are therefore modeled outside of the main measurement system(s). The resulting exposures, commonly referred to as add-ons, are then added to the portfolio potential-exposure measure. In limited cases, the use of conservative add-on methodologies may be suitable, if the central system cannot reflect the risk of complex financial products. However, overreliance on add-on methodologies may distort exposure measures. To mitigate measurement distortions, banking organizations should take the following steps:

- Review the use of add-on methodologies at least annually. Current or planned significant trading activity should trigger efforts to develop appropriate modeling and systems, prior to or concurrent with these growth plans.
- Establish growth limits for products with material activities that continue to rely on add-ons. Once systems are improved to meet a generally accepted industry standard of trade capture, these limits can be removed.

21. Banking organizations should consider the recommendations in the "Standards of Electronic Exchange of OTC Derivative Margin Calls," issued by the ISDA's Collateral Committee on November 12, 2009.

RISK MANAGEMENT

Counterparty Limits

Meaningful limits on exposures are an integral part of a CCR-management framework, and these limits should be formalized in CCR policies and procedures. For limits to be effective, a banking organization should incorporate these limits into an exposure monitoring system independent of relevant business lines. It should perform ongoing monitoring of exposures against such limits, to ascertain conformance with these limits, and have adequate risk controls that require action to mitigate limit exceptions. Review of exceptions should include escalation to a managerial level that is commensurate with the size of the excess or nature of mitigation required. A sound limit system should include the following:

- Establishment and regular review of counterparty limits by a designated committee. Further, a banking organization should have a process to escalate limit approvals to higher levels of authority, depending on the size of counterparty exposures, credit quality, and tenor.
- Establishment of potential future exposure limits, as well as limits based on other metrics. It is a sound practice to limit the market risk arising through CVA, with a limit on CVA or CVA VaR. However, such limits do not eliminate the need to limit counterparty credit exposure with a measure of potential future exposure.
- Individual CCR limits should be based on peak exposures rather than expected exposures.
  - — Peak exposures are appropriate for individual counterparty limit monitoring purposes because they represent the risk tolerance for exposure to a single counterparty.
  - — Expected exposure is an appropriate measure for aggregating exposures across counterparties in a portfolio credit model, or for use within CVA.
- Consideration of risk factors such as the credit quality of the counterparty, tenor of the transactions, and the liquidity of the positions or hedges.
- Sufficiently automated monitoring processes to provide updated exposure measures at least daily.
- Monitoring of intraday trading activity for conformance with exposure limits and excep-

tion policies. Such controls and procedures can include intraday-limit monitoring, trade procedures and systems that assess a trade's impact on limit utilization prior to execution, limit warning triggers at specific utilization levels, and restrictions by credit-risk management on allocation of full limits to the business lines.

Margin Policies and Practices

Collateral is a fundamental CCR mitigant. Indeed, significant stress events have highlighted the importance of sound margining practices. With this in mind, banking organizations should ensure that they have adequate margin and collateral "haircut"[22] guidelines for all products with CCR.[23] Accordingly, banking organizations should take the following actions:

- Maintain CCR policies that address margin practices and collateral terms, including, but not limited to
  - — processes to establish and periodically review minimum haircuts;
  - — processes to evaluate the volatility and liquidity of the underlying collateral. Banks should strive to ensure that haircuts on collateral do not decline during periods of low volatility; and
  - — controls to mitigate the potential for a weakening of credit standards from competitive pressure.
- Set guidelines for cross-product margining. Banking organizations offer cross-product-margining arrangements to clients to reduce required margin amounts. Guidelines to control risks associated with cross-product margining would include limiting the set of eligible transactions to liquid exposures and having procedures to resolve margin disputes.
- Maintain collateral-management policies and procedures to control, monitor, and report
  - — the extent to which collateral agreements expose a banking organization to collateral risks, such as the volatility and liquidity of the securities held as collateral;
  - — concentrations of less liquid or less marketable collateral asset classes;
  - — the risks of re-hypothecation or other reinvestment of collateral (both cash and non-cash) received from counterparties, including the potential liquidity shortfalls resulting from the reuse of such collateral; and
  - — the CCR associated with the decision whether to require posted margin to be segregated. Organizations should perform a legal analysis concerning the risks of agreeing to allow cash to be commingled with a counterparty's own cash and of allowing a counterparty to rehypothecate securities pledged as margin.
- Maintain policies and processes for monitoring margin agreements involving third-party custodians. As with bilateral counterparties, banking organizations should
  - — identify the location of the account to which collateral is posted or from which it is received;
  - — obtain periodic account statements or other assurances that confirm the custodian is holding the collateral in conformance with the agreement; and
  - — understand the characteristics of the account where the collateral is held (for example, whether it is in a segregated account) and the legal rights of the counterparty or any third-party custodian regarding this collateral.

Validation of Models and Systems

A banking organization should validate its CCR models initially and on an ongoing basis. Validation of models should include an evaluation of the conceptual soundness and developmental evidence supporting a given model; an ongoing monitoring process that includes verification of processes and benchmarking; and an outcomes-analysis process that includes backtesting. Validation should identify key assumptions and potential limitations, and it should assess their possible impact on risk metrics. All components of models should be subject to validation along with their combination in the CCR system.

Evaluating the conceptual soundness involves

22. A *haircut* is the difference between the market value of an asset being used as collateral for a loan and the amount of money that a lender will advance against the asset.

23. See the guidelines issued by ISDA, the Securities Industry and Financial Markets Association (SIFMA), and the Managed Funds Association (MFA), including the "Market Review of OTC Derivative Bilateral Collateralization Practices (Release 2.0)" (March 2010), and "Best Practices for Collateral Management" (June 30, 2010).

assessing the quality of the design and construction of the CCR models and systems, including documentation and empirical evidence that supports the theory, data, and methods used.

Ongoing monitoring confirms that CCR systems continue to perform as intended. This generally involves process verification, an assessment of model data integrity and systems operation, and benchmarking to assess the quality of a given model. Benchmarking is a valuable diagnostic tool in identifying potential weaknesses. Specifically, it is the comparison of a banking organization's CCR model estimates with those derived using alternative data, methods, or techniques. Benchmarking can also be applied to particular CCR model components, such as parameter-estimation methods or pricing models. Management should investigate the source of any differences in output, and determine whether benchmarking gaps indicate weakness in the banking organization's models.

Outcomes analysis compares model outputs to actual results during a sample period not used in model development. This is generally accomplished using backtesting. It should be applied to components of CCR models (for example, the risk-factor distribution and pricing model), the risk measures, and projected exposures. While there are limitations to backtesting, especially for testing the longer time-horizon predictions of a given CCR model, it is an essential component of model validation. Banking organizations should have a process for the resolution of observed model deficiencies detected by backtesting. This should include further investigation to determine the problem and appropriate course of action, including changing a given CCR model.

If the validation of CCR models and infrastructure systems is not performed by staff that is independent from the developers of the models, then an independent review should be conducted by technically competent personnel to ensure the adequacy and effectiveness of the validation. The scope of the independent review should include validation procedures for all components, the role of relevant parties, and documentation of the model and validation processes. This review should document its results, what action was taken to resolve findings, and its relative timeliness.

Senior management should be notified of validation and review results and should take appropriate and timely corrective actions to address deficiencies. The board should be apprised of summary results, especially unresolved deficiencies. In support of validation activities, internal audit should review and test models and systems validation as well as overall systems infrastructure as part of their regular audit cycle.

For more information on validation, please see this section's Appendix B.

Close-Out Policies and Practices

Banking organizations should have the ability to effectively manage counterparties in distress, including execution of a close-out. Policies and procedures outlining sound practices for managing a close-out should include the following:

- Requirements for hypothetical close-out simulations at least once every two years for one of the banking organization's most complex counterparties.
- Standards for the speed and accuracy with which the banking organization can compile comprehensive counterparty exposure data and net cash outflows. Operational capacity to aggregate exposures within four hours is a reasonable standard.
- The sequence of critical tasks, and decision-making responsibilities, needed to execute a close-out.
- Requirements for periodic review of documentation related to counterparty terminations, and confirmation that appropriate and current agreements that specify the definition of events of default and the termination methodology that will be used are in place.
  - Banking organizations should take corrective action if documents are not current, active, and enforceable.
  - Management should document their decision to trade with counterparties that are either unwilling or unable to maintain appropriate and current documentation.
- Established close-out methodologies that are practical to implement, particularly with large and potentially illiquid portfolios. Dealers should consider using the "close-out amount" approach for early termination upon default in interdealer relationships.[24]

24. Only for a definition of *close-out amount approach*, see the Counterparty Risk Management Policy Group III's report, "Containing Systemic Risk: Road to Reform" (August 6, 2008), pp. 122–125. Also, ISDA has published a closeout

- A requirement that the banking organization transmit immediate instructions to its appropriate transfer agent(s) to deactivate collateral transfers, contractual payments, or other automated transfers contained in "standard settlement instructions" for counterparties or prime brokers that have defaulted on the contract or for counterparties or prime brokers that have declared bankruptcy.

MANAGING CENTRAL COUNTERPARTY EXPOSURES

A central credit counterparty (CCP) facilitates trades between counterparties in one or more financial markets by either guaranteeing trades or novating contracts, and typically requires all participants to be fully collateralized on a daily basis. The CCP thus effectively bears most of the counterparty credit risk in transactions, becoming the buyer for every seller and the seller to every buyer. Well-regulated and soundly managed CCPs can be an important means of reducing bilateral counterparty exposure in the OTC derivatives market. However, CCPs also concentrate risk within a single entity. Therefore, it is important that banking organizations centrally clear through regulated CCPs with sound risk-management processes and strong financial resources sufficient to meet their obligations under extreme stress conditions.

To manage CCP exposures, banking organizations should regularly, but no less frequently than annually, review the individual CCPs to which they have exposures. This review should include performing and documenting due diligence on each CCP, applying current supervisory or industry standards[25] (and any subsequent standards) as a baseline to assess the CCP's risk-management practices.

- For each CCP, an evaluation of its risk-management framework should, at a minimum, include membership requirements, guarantee fund contributions, margining practices, default-sharing protocols, and limits of liability.
- Banking organizations should also consider the soundness of the CCP's policies and procedures, including procedures for handling the default of a clearing member, obligations at post-default auctions, and post-default assignment of positions.
- Banking organizations should also maintain compliance with applicable regulatory requirements, such as ensuring contingent loss exposure remains within a banking organization's legal lending limit.

LEGAL AND OPERATIONAL RISK MANAGEMENT

Banking organizations should ensure proper control of, and access to, legal documentation and agreements. In addition, it is important that systems used to measure CCR incorporate accurate legal terms and provisions. The accessibility and accuracy of legal terms is particularly critical in close-outs, when there is limited time to review the collateral and netting agreements. Accordingly, banking organizations should

- Have a formal process for negotiating legal agreements. As a best practice, the process would include approval steps and responsibilities of applicable departments.
- At least annually, conduct a review of the legal enforceability of collateral and netting agreements for all relevant jurisdictions.
- Maintain policies on when it is acceptable to trade without a master agreement,[26] using metrics such as trading volume or the counterparty's risk profile.
  - — Trading without a master agreement may be acceptable in cases of minimal volume or when trading in jurisdictions where master agreements are unenforceable. As applicable, policies should outline required actions to undertake and monitor transactions without an executed master agreement.
- Use commonly recognized dispute-resolution

amount protocol to aid in the adoption of the close-out amount approach.

25. For instance, see "Recommendations for Central Counterparties," a consultative report issued by the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commissions under the auspices of the Bank for International Settlements (March 2004).

26. The capital rules in the United States refer to master agreements. These include the Federal Reserve's "Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II," 12 CFR 208, Appendix F, and 12 CFR 225, Appendix G. For the FDIC, it is 12 CFR 325, Appendix D. For the OCC, see 12 CFR Part 3, Appendix C.

procedures.[27]

- — Banking organizations should seek to resolve collateral disputes within recommended time frames.
- — Senior management should receive reports listing material and aged disputes, as these pose significant risk.

- Include netting of positions in risk-management systems, only if there is a written legal review (either internally or externally) that expresses a high level of confidence that netting agreements are legally enforceable.
- Maintain ongoing participation in both bilateral and multilateral portfolio-compression efforts. Where feasible, banking organizations are encouraged to elect compression tolerances (such as post-termination factor sensitivity changes and cash payments) that allow the widest possible portfolio of trades to be terminated.
- Adopt and implement appropriate novation protocols.[28]

Legal Risk Arising from Counterparty Appropriateness[29]

While a counterparty's ability to pay should be evaluated when assessing credit risk, credit losses can also occur when a counterparty is unwilling to pay, which most commonly occurs when a counterparty questions the appropriateness of a contract. These types of disputes pose not only risk of a direct credit loss, but also risk of litigation costs and/or reputational damage. Banking organizations should maintain policies and procedures to assess client and deal appropriateness. In addition, banking organizations should

- Conduct initial and ongoing due diligence, evaluating whether a client is able to understand and utilize transactions with CCR as part of assessing the client's sophistication, investment objectives, and financial condition.
  - — For example, although some clients may be sophisticated enough to enter into a standardized swap, they may lack the sophistication to fully analyze the risks of a complex OTC deal.
  - — Banking organizations should be particularly careful to assess appropriateness of complex, long-dated, off-market, illiquid, or other transactions with higher reputational risk.
- Include appropriateness assessments in the new-product approval process. Such assessments should determine the types of counterparties acceptable for a new product, and what level of counterparty sophistication is required for any given product.
- Maintain disclosure policies for OTC derivative and other complex transactions to ensure that risks are accurately and completely communicated to counterparties.
- Maintain guidelines for determination of acceptable counterparties for complex derivatives transactions.

CONCLUSION ON COUNTERPARTY CREDIT-RISK MANAGEMENT

For relevant banking organizations, CCR management should be an integral component of the risk-management framework. When considering the applicability of specific guidelines and best practices set forth in this guidance, a banking organization's senior management and supervisors should consider the size and complexity of its securities and trading activities. Banking organizations should comprehensively evaluate existing practices against the standards in this guidance and implement remedial action as appropriate. A banking organization's CCR exposure levels and the effectiveness of its CCR management are important factors for a supervisor to consider when evaluating a banking organization's overall management, risk management, and credit- and market-risk profile.

APPENDIX A: GLOSSARY

This glossary describes commonly used CCR metrics. As discussed above, banking organizations should employ a suite of metrics commensurate with the size, complexity, liquidity, and risk profile of the organization's CCR portfolio.

27. An example of such procedures would be the ISDA's "2009 Dispute Resolution Protocol" (September 2009).

28. An example would be the ISDA's novation protocol.

29. For guidance on counterparty appropriateness, see section 4033.1 of this manual; section 2128.09 in the *Bank Holding Company Supervision Manual*; section 2070 of the *Trading and Capital-Markets Activities Manual*; and SR-07-5, "Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities" (January 11, 2007).

Major broker-dealer banking organizations should employ the full range of risk-measurement metrics to enable a comprehensive understanding of CCR and how it changes in varying environments. Banking organizations of lesser size and complexity should carefully consider which of these metrics they need to track as part of their exposure risk-management processes. At a minimum, all banking organizations should calculate current exposure and stress test their CCR exposures. Definitions marked with an asterisk (*) are from the Bank for International Settlements.

Exposure Metrics

Current exposure is the larger of zero, or the market value of a transaction or a portfolio of transactions within a netting set with a counterparty that would be lost upon the default of the counterparty, assuming no recovery on the value of those transactions in bankruptcy. Current exposure is often also called replacement cost. Current exposure may be reported gross or net of collateral. Current exposure allows banking organizations to assess their CCR exposure at any given time—that is, the amount currently at risk.

Jump-to-default (JTD) exposure is the change in the value of counterparty transactions upon the default of a reference name in CDS positions. This allows banking organizations to assess the risk of a sudden, unanticipated default before the market can adjust.

Expected exposure is calculated as average exposure to a counterparty at a date in the future. This is often an intermediate calculation for expected positive exposure or CVA. It can also be used as a measure of exposure at a common time in the future.

Expected positive exposure (EPE) is the weighted average over time of expected exposures when the weights are the proportion that an individual expected exposure represents of the entire time interval. Expected positive exposure is an appropriate measure of CCR exposure when measured in a portfolio credit-risk model.*

Peak exposure is a high percentile (typically 95 percent or 99 percent) of the distribution of exposures at any particular future date before the maturity date of the longest transaction in the netting set. A peak exposure value is typically generated for many future dates up until the longest maturity date of transactions in the netting set. Peak exposure allows banking organizations to estimate their maximum potential exposure at a specified future date, or over a given time horizon, with a high level of confidence. For collateralized counterparties, this metric should be based on a realistic close-out period, considering both the size and liquidity of the portfolio. Banking organizations should consider peak potential exposure when setting counterparty credit limits.*

Expected shortfall exposure is similar to peak exposure, but is the expected exposure conditional on the exposure being greater than some specified peak percentile. For transactions with very low probability of high exposure, the expected shortfall accounts for large losses that may be associated with transactions with high-tail risk.

Sensitivity to market risk factors is the change in exposure because of a given market-risk-factor change (for example, a position's change in price resulting from a 1 basis point change in interest rates). It provides information on the key drivers of exposure to specific counterparties and on hedging.

Stressed exposure is a forward-looking measure of exposure based on predefined market-factor movements (nonstatistically generated). These can include single-factor market shocks, historical scenarios, and hypothetical scenarios. Stressed exposure allows banking organizations to consider their counterparty exposure under a severe or stressed scenario. This serves as a supplemental view of potential exposure, and provides banking organizations with additional information on risk drivers. The best practice is to compare stressed exposure to counterparty credit limits.

CVA-Related Metrics

Credit valuation adjustment (CVA) is an adjustment to the mid-market valuation (average of the bid and asked price) of the portfolio of trades with a counterparty. This adjustment reflects the market value of the credit risk resulting from any failure to perform on contractual agreements with a counterparty. This adjustment may reflect the market value of the credit risk of the counterparty or the market value of the credit risk of both the banking organization and the counterparty. CVA is a measure of the market value of CCR, incorporating both counterparty creditworthiness and the variability of exposure.*

CVA VaR is a measure of the variability of the CVA mark-to-market value and is based on the projected distributions of both exposures and counterparty creditworthiness. CVA VaR provides banking organizations with an estimate of the potential CVA mark-to-market loss, at a certain confidence interval and over a given time horizon.

CVA factor sensitivities is the mark-to-market change in CVA resulting from a given market-risk-factor change (for example, a position's change in price resulting from a 1 basis point change in credit spreads). CVA factor sensitivities allow banking organizations to assess and hedge the market value of the credit or market risks to single names and portfolios and permit banking organizations to monitor excessive build ups in counterparty concentrations.

Stressed CVA is a forward-looking measure of CVA mark-to-market value based on predefined credit- or market-factor movements (nonstatistically generated). These can include single-market-factor shocks, historical scenarios, and hypothetical scenarios. Stressed CVA serves as an informational tool and allows banking organizations to assess the sensitivity of their CVA to a potential mark-to-market loss under defined scenarios.

APPENDIX B: DETAIL ON MODEL VALIDATION AND SYSTEMS EVALUATION

A banking organization should validate its CCR models, initially and on an ongoing basis. Validation should include three components: (1) an evaluation of the conceptual soundness of relevant models (including developmental evidence); (2) an ongoing monitoring process that includes verification of processes and benchmarking; and (3) an outcomes-analysis process that includes backtesting. The validation should either be independent or subject to independent review.

Validation is the set of activities designed to give the greatest possible assurances of CCR models' accuracy and systems' integrity. Validation should also identify key assumptions and potential limitations and assess their possible impact on risk metrics. CCR models have several components:

- statistical models to estimate parameters, including the volatility of risk factors and their correlations
- simulation models to convert those parameters into future distributions of risk factors
- pricing models that estimate value in simulated scenarios
- calculations that summarize the simulation results into various risk metrics

All components of each model should be subject to validation, along with analysis of their interaction in the CCR system. Validation should be performed initially when a model first goes into production. Ongoing validation is a means of addressing situations where models have known weaknesses and ensuring that changes in markets, products, or counterparties do not create new weaknesses. Senior management should be notified of the validation results and should take corrective actions in a timely manner when appropriate.

A banking organization's validation process should be independent of the CCR model and systems development, implementation, and operation. Alternately, the validation should be subject to independent review, whereby the individuals who perform the review are not biased in their assessment because of involvement in the development, implementation, or operation of the processes or products. Individuals performing the reviews should possess the requisite technical skills and expertise to provide critical analysis, effective challenge, and appropriate recommendations. The extent of such reviews should be fully documented, sufficiently thorough to cover all significant model elements, and include additional testing of models or systems as appropriate. In addition, reviewers should have the authority to effectively challenge developers and model users, elevate concerns or findings as necessary, and either have issues addressed in a prompt and substantial manner or reject a model for use by the banking organization.

Conceptual Soundness and Developmental Evidence

The first component of validation is evaluating conceptual soundness, which involves assessing the quality of the design and construction of CCR models. The evaluation of conceptual soundness includes documentation and empirical evidence supporting the theory, data, and methods used. The documentation should also identify key assumptions and potential limitations and assess their possible impact. A comparison to industry practice should be done to identify areas where substantial and warranted improvements can be made. All model components are subject to evaluation, including simplifying assumptions, parameter calibrations, risk-factor diffusion processes, pricing models, and risk metrics. Developmental evidence should be reviewed whenever the banking organization makes material changes in CCR models. Evaluating conceptual soundness includes independent evaluation of whether a model is appropriate for its purpose and whether all underlying assumptions, limitations, and shortcomings have been identified and their potential impact assessed.

Ongoing Monitoring, Process Verification, and Benchmarking

The second component of model validation is ongoing monitoring to confirm that the models were implemented appropriately and continue to perform as intended. This involves process verification, an assessment of models, and benchmarking to assess the quality of the model. Deficiencies uncovered through these activities should be remediated promptly.

Process verification includes evaluating data integrity and operational performance of the systems supporting CCR measurement and reporting. This should be performed on an ongoing basis and includes

- the completeness and accuracy of the transaction and counterparty data flowing through the counterparty exposure systems;
- reliance on up-to-date reviews of the legal enforceability of contracts and master netting agreements that govern the use of netting and collateral in systems measuring net exposures and the accuracy of their representations in the banking organization's systems;
- the integrity of the market data used within the banking organization's models, both as current values for risk factors and as sources for parameter calibrations; and
- the operational performance of the banking organization's counterparty exposure calculation systems, including the timeliness of the batch-run calculations, the consistent integration of data coming from different internal or external sources, and the synchronization of exposure, collateral management, and finance systems.

"Benchmarking" means comparing a banking organization's CCR measures with those derived using alternative data, methods, or techniques. It can also be applied to particular model components, such as parameter estimation methods or pricing models. It is an important complement to backtesting and is a valuable diagnostic tool in identifying potential weaknesses. Differences between the model and the benchmark do not necessarily indicate that the model is in error because the benchmark itself is an alternative prediction. It is important that a banking organization use appropriate benchmarks, or the exercise will be compromised. As part of the benchmarking exercise, the banking organization should investigate the source of the differences and whether the extent of the differences is appropriate.

Outcomes Analysis Including Backtesting

The third component of validation is outcomes analysis, which is the comparison of model outputs to actual results during a sample period not used in model development. Backtesting is one form of out-of-sample testing. Backtesting should be applied to components of a CCR model, for example the risk factor distribution and pricing model, as well as the risk measures and projected exposures. Outcomes analysis includes an independent evaluation of the design and results of backtesting to determine whether all material risk factors are captured and to assess the accuracy of the diffusion of risk factors and the projection of exposures. While there are limitations to backtesting, especially for testing the longer horizon predictions of a CCR model, banking organizations should incorporate it as an essential component of model validation.

Typical examples of CCR models that require backtesting are expected exposure, peak exposure, and CVA VaR models. Backtesting of models used for measurement of CCR is substantially different than backtesting VaR models for market risk. Notably, CCR models are applied to each counterparty facing the banking organization, rather than an aggregate portfolio. Furthermore, CCR models should project the distribution over multiple dates and over long time horizons for each counterparty. These complications make the interpretation of CCR backtesting results more difficult than that for market risk. Because backtesting is critical to providing feedback on the accuracy of CCR models, it is particularly important that banking organizations exert considerable effort to ensure that backtesting provides effective feedback on the accuracy of these models.

Key elements of backtesting include the following activities:

- Backtesting programs should be designed to evaluate the effectiveness of the models for typical counterparties, key risk factors, key correlations, and pricing models. Backtesting results should be evaluated for reasonableness as well as for statistical significance. This may serve as a useful check for programming errors or cases in which models have been incorrectly calibrated.
- Backtesting should be performed over different time horizons. For instance, the inclusion of mean reversion parameters or similar time varying features of a model can cause a model to perform adequately over one time horizon, but perform very differently over a different time horizon. A typical large dealer should, at a minimum, perform backtesting over one day, one week, two weeks, one month, and every quarter out to a year. Shorter time periods may be appropriate for transactions under a collateral agreement when variation margin is exchanged frequently, even daily, or for portfolios that contain transactions that expire or mature in a short time frame.
- Backtesting should be conducted on both real counterparty portfolios and hypothetical portfolios. Backtesting on fixed hypothetical portfolios provides the opportunity to tailor backtesting portfolios to identify whether particular risk factors or correlations are modeled correctly. In addition, the use of hypothetical portfolios is an effective way to meaningfully test the predictive abilities of the counterparty exposure models over long time horizons. Banking organizations should have criteria for their hypothetical portfolios. The use of real counterparty portfolios evaluates whether the models perform on actual counterparty exposures, taking into account portfolio changes over time.

It may be appropriate to use backtesting methods that compare forecast distributions of exposures with actual distributions. Some CCR measures depend on the whole distribution of future exposures rather than a single exposure percentile—for example, expected exposure (EE) and expected positive exposure (EPE). For this reason, sole reliance on backtesting methods that count the number of times an exposure exceeds a unique percentile threshold may not be appropriate.

Exception counting remains useful, especially for evaluating peak or percentile measures of CCR, but these measures will not provide sufficient insight for expected exposure measures. Hence, banking organizations should test the entire distribution of future exposure estimates and not just a single percentile prediction.

Banking organizations should have policies and procedures in place that describe when backtesting results will generate an investigation into the source of observed backtesting deficiencies and when model changes should be initiated as a result of backtesting.

Documentation

Adequate validation and review are contingent on complete documentation of all material aspects of CCR models and systems. This should include all model components and parameter estimation or calibration processes. Documentation should also include the rationale for all material assumptions underpinning its chosen analytical frameworks, including the choice of inputs; distributional assumptions; and weighting of quantitative and qualitative elements. Any subsequent changes to these assumptions should also be documented and justified.

The validation or independent review should be fully documented. Specifically, this would include results, the scope of work, conclusions and recommendations, and responses to those recommendations. This includes documentation of each of the three components of model validation, discussed above. Complete documentation should be done initially and updated over time to reflect ongoing changes and model performance. Ability of the validation (or review) to provide effective challenge should also be documented.

Internal Audit

A banking organization should have an internal audit function, independent of business-line management, which assesses the effectiveness of the model validation process. This assessment should ensure the following: proper validation procedures were followed for all components of the CCR model and infrastructure systems; required independence was maintained by validators or reviewers; documentation was adequate for the model and validation processes; and results of validation procedures are elevated, with timely responses to findings. Internal audit should also evaluate systems and operations that support CCR. While internal audit may not have the same level of expertise as quantitative experts involved in the development and validation of the model, they are particularly well suited to evaluate process verification procedures. If any validation or review work is outsourced, internal audit should evaluate whether that work meets the standards discussed in this section.

INTRODUCTION

Off-balance-sheet credit activities have been one of the fastest growing areas of banking activity. Although these activities may not be reflected on the balance sheet, they must be thoroughly reviewed because they can expose the bank to contingent liabilities. Contingent liabilities are financial obligations of a bank that are dependent on future events or actions of another party.

The purpose of this section is to provide a concise reference for contingent liabilities that arise from off-balance-sheet credit activities (for example, loan commitments and letters of credit). This section will also include some discussion of other contingent liabilities, which arise from asset sales and other off-balance-sheet activities. Activities such as trusts, securities clearance, securities brokerage, and corporate management advisory services involve significant operational and fiduciary risks and require specialized examination procedures. Consult section 6010, ‘‘Other Types of Examinations,’’ in this manual for further information about these activities.

Derivatives are also not covered in this section. The acquisition and management of derivatives for the bank's own account are covered in detail in sections 2020 and 4090, ‘‘Acquisition and Management of Nontrading Securities and Derivative Instruments’’ and ‘‘Interest-Rate Risk Management’’ of this manual. The *Trading Activities Manual* provides more specific guidance for the examination of banks that are involved in derivatives trading and customer accommodation activities.

Risks associated with contingent liabilities may ultimately result in charges against capital. As a result, full-scope examinations will include an analysis of these risks. Each of the major components of the examination—capital, asset quality, management, liquidity, and earnings—incorporates an assessment of the risks associated with off-balance-sheet credit activities. While it is impossible to enumerate all of the types and characteristics of contingent liabilities here, some of the more common ones are discussed in this section. In all cases, the examiner's overall objectives are to assess the potential impact of these contingent liabilities on the financial condition of the bank, to ascertain the likelihood that such contingencies may ultimately result in losses to the bank, to ensure that management has appropriate systems to identify and control contingent liabilities, and to ensure compliance with all applicable laws, regulations, and statements of regulatory policy.

OFF-BALANCE-SHEET LENDING ACTIVITIES

In reviewing individual credit lines, all of a customer's borrowing arrangements with the bank (for example, direct loans, letters of credit, and loan commitments) should be considered. The factors analyzed in evaluating a direct loan (financial performance, ability and willingness to pay, collateral protection, and future prospects) are applicable to the review of off-balance-sheet lending arrangements. When analyzing these activities, however, examiners should evaluate the probability of draws under the bank's off-balance-sheet lending arrangements with its customers and should evaluate whether the allowance for loan and lease losses adequately reflects the associated risks. Consideration should also be given to compliance with laws and regulations. Refer to section 2040, ‘‘Loan Portfolio Management,’’ of this manual for further details.

Loan Commitments

A formal loan commitment is a written agreement signed by the borrower and the lender that details the terms and conditions under which a loan, up to a specified amount, will be made. Unlike a standby letter of credit, which commits the bank to satisfying its customer's obligation to a third party, a loan commitment involves only the bank and its customer. The commitment will have an expiration date and, in exchange for agreeing to make the accommodation, the bank often requires the customer to pay a fee and/or maintain a stipulated compensating balance.

Some commitments, such as a working capital line, revolving credit facility, or a term loan facility, are expected to be used. Other commitments, such as back-up lines of credit for commercial paper issuance, involve usage that is not anticipated unless the customer is unable to retire or roll over the issue at maturity.

Lines of Credit

A line of credit expresses to the customer, usually by letter, a bank's willingness to lend up to a certain amount over a specified timeframe. These lines of credit are disclosed to the customer and are referred to as "advised" or "confirmed" lines. In contrast, "guidance" lines (also referred to as internal guidance lines) are not disclosed to the customer. "Guidance" lines of credit are formally approved like any other loans or commitments and are established to aid the loan officer who is servicing an account act quickly to an unexpected request for funds. Many lines of credit may be cancelled if the customer's financial condition deteriorates; others are simply subject to cancellation at the option of the issuer, such as "guidance" lines and other nonbinding agreements. Lines of credit usually require periodic or annual borrowing cleanups. Not adhering to cleanup provisions is a well-defined weakness.

Disagreements may arise as to what constitutes a legally binding commitment. A bank's own descriptive terminology alone may not always be the best guideline. For example, a credit arrangement could be referred to as a revocable line of credit but, at the same time, it may be a legally binding commitment to lend—especially if consideration has been given by the customer for the bank's promise to lend and if the terms of the agreement between the parties result in a contract. Therefore, management of the bank should properly distinguish its legally binding loan commitments from its revocable loan commitments. Proper documentation will help ensure that the bank's position is defensible if legal action becomes necessary to cancel a loan commitment.

Some lending agreements contain a "material adverse change" (MAC) clause, which is intended to allow the bank to terminate the commitment or line of credit if the customer's financial condition deteriorates. This clause may apply to the continuing financial condition of guarantors. The extent to which MAC clauses are enforceable depends on several factors, including whether a legally binding relationship remains despite specific financial covenants that are violated. Some documents make only a vague reference to a borrower's responsibility for maintaining a satisfactory financial condition. Although the enforceability of MAC clauses may be subject to some uncertainty, such clauses may provide the bank with leverage in negotiations with the customer over such issues as requests for additional collateral and/or personal guarantees.

A bank cannot always routinely determine whether funding of a commitment or line of credit will be required; therefore, the examiner must always subject the line of credit to careful analysis. A MAC clause could allow the bank to refuse funding to a financially troubled borrower; a default in other contract covenants could cause the termination of the commitment or line of credit. Some banks might strictly enforce the terms of a credit arrangement and refuse funding if any of the covenants are broken. Other banks take a more accommodating approach and will continue to make advances unless the customer files for bankruptcy. In the final analysis, the procedures normally followed by the bank in honoring or terminating a contingent lending agreement are important in the examiner's overall evaluation of the credit risk.

Risk Management for Loan Commitments and Lines of Credit

The primary risk inherent in any future extension of credit is that the condition of the borrower may change between the issuing of the commitment and its funding. However, commitments may also entail liquidity and interest-rate risk.

Examiners should evaluate anticipated drawdowns of an issuing bank's loan commitments and lines of credit relative to the bank's anticipated funding sources. A draw under lines of credit may be in the form of a letter of credit issued on the borrower's behalf. Such letters of credit share the same collateral as the line of credit, and the issuance of the letter of credit uses availability under the line. At each examination, the draws that are anticipated for unused commitments and advised lines of credit should be estimated. If the amount of unfunded commitments is large relative to the bank's liquidity position, further analysis is suggested to determine whether borrowed funds will have to be used and, if so, the amount and sources of such funds. Concerns and comments should be noted on the Liquidity/Funds Management page in the report of examination. Also, loan commitments are to be reported on the commitments and contingencies schedule in the report of examination. For further information, refer to sections 4020, 4090, and 6000, "Asset/Liability Management," "Interest-Rate Risk Management," and "Instructions for the Report of Examination," in this manual.

LETTERS OF CREDIT

A letter of credit substitutes the credit capacity of a financial institution for that of an individual or a corporation. The concept of substituting one obligor's financial standing for another party's financial standing has been used in financing the international shipment of merchandise for centuries (imports and exports). Today, letters of credit are also used in a wide variety of other commercial financing transactions, such as guaranteeing obligations involving the private placement of securities and ensuring payment in the event of nonperformance of an obligated party. In addition, letters of credit are used to secure the guarantees of principals in real estate development loans. For additional information on letters of credit, see section 7080, "International—Letters of Credit," in this manual.

Elements of a Letter of Credit

A letter of credit should contain the following elements:

- a conspicuous statement that the document is a letter of credit
- a specified expiration date or a definite term and an amount
- an obligation of the issuer to pay that is solely dependent on the presentation of conforming documents as specified in the letter of credit and not on the factual performance or nonperformance by the parties to the underlying transaction
- an unqualified obligation of the account party to reimburse the issuer for payments made under the letter of credit

A letter of credit involves at least three parties and is three separate and distinct contracts:

- a contract between the account party and the beneficiary under which the account party has an obligation of payment or performance
- a contract between the account party and the issuer of the letter of credit (The issuer is the party obligated to pay when the terms of the letter of credit are satisfied. The account party agrees to reimburse the issuer for any payments made.)
- a contract between the issuer and the beneficiary, whereby the issuer agrees to pay the beneficiary in compliance with the terms and conditions of the letter

Policies and Procedures

Maintaining adequate written policies and procedures and monitoring letters of credit activities are part of the fiduciary and oversight responsibilities of the board of directors. Generally, policies and procedures governing the institution's issuance of letters of credit are contained in a section of the loan policy manual.

The letter of credit policy should thoroughly explain the institution's procedures in issuing both commercial letters of credit and standby letters of credit. The policy should outline desirable and undesirable issuances, designate persons authorized to issue letters of credit and their corresponding loan authority, and define the recordkeeping and documentation requirements including the need to establish separate files for each issuance.

If several lending departments issue letters of credit, the policy should explicitly assign responsibility for file maintenance and recordkeeping. A separate file containing an exact copy of each outstanding letter of credit and all the supporting documentation that the underwriter used in deciding to issue the letter should be included in the file. This documentation should be the same as the financial documentation used for originating any other form of credit, which includes current financial statements, current income statements, purpose of the letter of credit, collateral-security documentation, proof-of-lien position, borrowing authorization, all correspondence, and officers' memoranda.

Documentation

In addition, the file must contain the documentation associated with any disbursements or payments made. For a commercial letter of credit, these documents may include—

- the draft (sometimes called the bill of exchange), which is the demand for payment;
- the commercial invoice, a document describing the goods being shipped (prepared by the seller and signed by the buyer);
- the bill of lading, which documents that shipment of the goods has taken place and gives the issuer an interest in the goods in the event the account party defaults;
- customs documentation that verifies that all required duties have been paid;
- the insurance certificate, which provides evidence that the seller has procured insurance;
- the consular documents, which state that the shipment of goods satisfies the import/export regulations; and
- the certificates of origin and inspection, which state that the goods originated in a specified country to guard against the substitution of second-quality merchandise.

The documents associated with standby letters of credit are far less complicated than those for commercial letters of credit. Often no document is necessary to support the beneficiary's draw upon a standby letter of credit. This is what is referred to as a clean standby letter of credit and should be discouraged due to the possible legal expense of defending any action taken in honoring or dishonoring a draw without specific documentary requirements. At a minimum, standby letters of credit should require a beneficiary's certificate asserting that the account party has not performed according to the contract or has defaulted on the obligation, as well as a copy of the contract between the account party and beneficiary.

Accounting Issues

Since letters of credit represent a contingent liability to the issuing institution, they must be disclosed in the financial statements in accordance with generally accepted accounting principles (GAAP). The Financial Accounting Standards Board has stipulated in its Statement of Financial Accounting Standard No. 5 that the nature and the amount of a standby letter of credit must be disclosed in the institution's financial statement. Commercial letters of credit and standby letters of credit should be accounted for on the balance sheet as liabilities if it is probable that the bank will disburse funds, and if the amount of the funding is determinable. Most standby letters of credit will not be recorded as a liability. However, their existence will be disclosed in the footnotes to the financial statements.

Benefits of Letters of Credit

Both the customer and the financial institution can benefit from letters of credit. Through the use of a letter of credit, a customer can often obtain a less expensive source of funds than would be possible through direct financing from the institution. For example, the customer may be able to take advantage of a seller's credit terms with the backing of a letter of credit to substantiate the customer's credit capacity. The institution receives a fee for providing the service. In addition, the institution hopes to build a better working relationship with its customers, who may generate or refer other profitable business.

Revocable or Irrevocable

Letters of credit can be issued as either revocable or irrevocable. The revocable letter of credit is rarely used because it may be amended or canceled by the issuer without the consent of the other parties. Most letters of credit are issued as irrevocable with a stipulation that no changes may be made to the original terms without the full consent of all parties.

Risks in Issuing Letters of Credit

A financial institution must be aware of the credit risks that are associated with letters of credit and must issue letters of credit only when its resources are adequate. Although letters of credit are not originally made as loans, they may lead to loans if the account party cannot meet its obligations. Therefore, the institution must implement the same prudent underwriting guidelines for letters of credit as for other extensions of commercial credit. Refer to section 2080, "Commercial Loans," in this manual for further details.

The importance of adequate documentation cannot be overemphasized. Commercial letters of credit are part of a continuous flow of transactions evolving from letters of credit to sight drafts to acceptances. Repayment may depend on the eventual sale of the goods involved; however, the goods may not provide any collateral protection. Thus, proper handling and accuracy of the required documents are of primary concern. Letters of credit are frequently issued via tested telex, which verifies the authenticity of the sender (usually another bank). No institution should honor a letter of credit presented by a beneficiary without first confirming its authenticity.

Commercial letters of credit involving imports must be considered unsecured until the goods have passed customs, the security documents specified in the letter of credit have been presented, and the goods have been verified and controlled.

Letters of credit are subject to the risk of fraud perpetrated by customers, beneficiaries, or insiders of the issuing institution. Moreover, standby letters of credit can be used by officers or directors as a vehicle for obtaining credit at another institution. It is important to note that Regulation O requirements apply to standby letters of credit.

Consequently, letters of credit should be issued under the same strict internal controls as any other extension of credit. Such controls include a requirement of dual or multilevel authorizations and the segregation of the issuing, recordkeeping, acceptance, and payment functions.

Risks in Honoring Letters of Credit

The honoring of another institution's letter of credit or acceptance requires strict verification procedures as well as dual authorization by the honoring financial institution. Reasons for strict procedures and authorizations are numerous. The issuer may be unable or unwilling to honor a letter of credit or standby letter of credit, claiming that the document is fraudulent or a forgery or that the signer was unauthorized. Before honoring any other institution's letter of credit, a bank should confirm in writing that the letter of credit is valid and will be honored under specified conditions. Agreements with issuers for accepting letters of credit issued by tested telex should provide specific conditions under which they will be honored.

To minimize risks of loss, compliance with the conditions outlined within the letter of credit must be strict—not merely substantial. Testing of LOCs should involve two or more persons through dual authorization or segregation of duties to prevent fraud by employees in this process.

Uniform Commercial Code

Both the issuer and the beneficiary of letters of credit are obligated to conform to a uniform set of rules governed by article 5 of the Uniform Commercial Code (UCC). These rules are referenced in the Uniform Customs and Practice for Documentary Credits (UCP). The UCC is a set of articles governing commercial transactions adopted by various states, whereas the UCP encompasses all of the international guidelines for trading goods and services. Local laws and customs vary and must be followed under advice of counsel.

TYPES OF LETTERS OF CREDIT

There are two major types of letters of credit: the commercial letter of credit, also referred to as a trade letter of credit, and the standby letter of credit. Banks have significantly increased their issuances of letters of credit, particularly standby letters. A contributing factor to this significant increase is that by issuing letters of credit, an institution can increase its earnings without disbursing funds and increasing total assets. The institution charges a fee for the risk of default or nonperformance by the customer, thereby increasing the bank's return on average assets. It is important for examiners to be concerned with the elements of risk that are present in the institution's practices regarding the issuance of letters of credit. Examiners should then assess the institution's system of controls that can mitigate the risks (including staff experience, proper documentation, and the quality of underwriting). The standards for issuing letters of credit should be no less stringent than the standards for making a loan. Likewise, the letter-of-credit portfolio requires a review as thorough as the lending review. A default or nonperformance by the account party of a letter of credit will have the same impact as a default on a loan.

Commercial Letters of Credit

The commercial letter of credit (LOC) is commonly used as a means of financing the sale of goods between a buyer and seller. Generally, a seller will contract with a buyer on an open-account basis, whereby the seller ships the goods to the buyer and submits an invoice. To avoid the risk of nonpayment, the seller may require the buyer to provide a commercial letter of credit. To satisfy the requirement, the buyer applies for a letter of credit at a financial institution. If approved, the letter of credit would contain specified terms and conditions in favor of the seller (beneficiary), and the buyer (account party) would agree to reimburse the financial institution for payments drawn against the letter. The commercial letter of credit can be used to finance one shipment or multiple shipments of goods. Once documents that provide evidence that the goods have been shipped in accordance with the terms of the letter of credit are received, the seller can draw against the issued letter of credit through a documentary draft or a documentary demand for payment. The institution honors the draft, and the buyer incurs an obligation to reimburse the institution.

Letters of credit can be secured by cash deposits, a lien on the shipped goods or other inventory, accounts receivable, or other forms of collateral. Commercial letters of credit "sold for cash" (that is, secured by cash deposits) pose very little risk to a bank as long as the bank, before making payment on the draft, ensures that the beneficiary provides the proper documents. If credit is extended to pay for the goods, the subsequent loan presents the same credit risks associated with any other similar loan.

Standby Letters of Credit

The standby letter of credit (SBLOC) is an irrevocable commitment on the part of the issuing institution to make payment to a designated beneficiary if the institution's customer, the account party, defaults on an obligation. The SBLOC differs from the commercial letter of credit because it is not dependent on the movement of goods. While the commercial letter of credit eliminates the beneficiary's risk of nonpayment under the contract of sale, the SBLOC eliminates the financial risks resulting from nonperformance under a contract. The SBLOC, in effect, enhances the credit standing of the bank's customer.

SBLOCs may be financially oriented (financial SBLOCs), whereby an account party agrees to make payment to the beneficiary, or SBLOCs may be service-oriented (performance SBLOCs), whereby the financial institution guarantees to make payment if its customer fails to perform a nonfinancial contractual obligation.

Financial SBLOCs

Financial SBLOCs are often used to back direct financial obligations such as commercial paper, tax-exempt securities, or the margin requirements of exchanges. For example, if the bank's customer issues commercial paper supported by an SBLOC, and the bank's customer is unable to repay the commercial paper at maturity, the holder of the commercial paper may request the bank to make payment. Upon receipt of the request, the bank would repay the holders of the commercial paper and account for the payment as a loan to the customer under the letter of credit. Because of this irrevocable commitment, the bank has, in effect, directly substituted its credit for that of its customer upon the issuance of the SBLOC; consequently, the SBLOC has become a credit enhancement for the customer.

Performance SBLOCs

Performance SBLOCs are generally transaction-specific commitments that the issuer will make payment if the bank's customer fails to perform a nonfinancial contractual obligation, such as to ship a product or provide a service. Performance SBLOCs are often used to guarantee bid or performance bonds. Through a performance SBLOC, the bank provides a guaranty of funds to complete a project if the account party does not perform under the contract. In contrast to the financial SBLOC, the bank's irrevocable commitment provides liquidity to the obligor and not directly to a third-party beneficiary.

Unlike a commercial letter of credit, a demand for payment against an SBLOC is generally an indication that something is wrong. The nonperformance or default that triggers payment under the SBLOC often signals the financial weakness of the customer, whereas payment under a commercial letter of credit suggests that the account party is conducting its business as usual. Standby letters of credit can be either unsecured or secured by a deposit or other form of collateral.

Uses

The uses of standby letters of credit are practically unlimited. The more common areas of use include the following.

Financing Real Estate Development. A mortgagee will condition its loan commitment upon a cash contribution to a project by the developers. Although the lender insists that the developers have some equity in the project, the developer may not have funds available as they are tied up in other projects. The parties often use the letter of credit to satisfy the requirement for equity without the need for a cash deposit.

Fulfilling Municipal Regulations. Most municipalities require some form of a performance bond to ensure that infrastructure improvements, such as buildings, roads, and utility services, are completed. Because the bonding companies generally required a letter of credit as collateral for their bond, developers began offering the SBLOC to the municipality as a substitute. The SBLOC is probably more common than the performance bond. The SBLOC provides the municipality the guaranty of funds to complete necessary improvements if the developer does not perform as required.

Securing Notes. A lender will sometimes ask its obligor to secure the balance of a promissory note with an SBLOC issued by another bank.

Ensuring Performance. The standby letter of credit is similar to a performance bond. Often the seller of goods will have the borrower obtain a commercial letter of credit to ensure payment; simultaneously, the buyer will have the seller obtain a standby letter of credit to ensure that the goods are delivered when agreed and in acceptable condition.

Guaranteeing Securities. The standby letter of credit guarantees obligations involving the private placement of securities, such as revenue and development bonds. If an SBLOC secures against default, such paper will generally have a higher rating and bear a lower rate of interest. An SBLOC could also be used as a credit enhancer for packaging retail loans for public sale. The use of an SBLOC in this situation typically carries minimal overall risk because the packaging institution normally sets aside a contingent reserve for losses. However, if the reserve is inadequate, the SBLOC should be reviewed for possible classification.

SBLOCs Issued as Surety for Revenue Bonds

SBLOCs may be issued in conjunction with the development of a property that is financed with tax-free or general revenue bonds. In these transactions, a municipal agency—typically, a local housing authority or regional development authority—sells bonds to investors in order to finance the development of a specific project. Once the bonds are issued, the proceeds are placed with a trustee and then loaned at less than market rates to the developer of the project. The below-market-rate loan that is granted to the developer enables the municipal agency to encourage development without expending tax dollars. The municipal agency has no liability; the bond investors only have recourse against the specific project. If the bonds are exempt from federal taxation, they will generally carry a below-market interest rate. If the bonds are not tax free—and some municipal bonds are not tax free—they will carry a market rate of interest.

Because the bonds are secured only by the project, an SBLOC is typically obtained by the beneficiary (in this example, the municipal agency) from a financial institution to provide additional security to the bondholders. The SBLOC is usually for an amount greater than the face amount of the bonds, so the bondholders' accrued interest between interest payment dates is usually secured. The bank generally secures its SBLOC with a lien that is subordinate to the authority's or trustees' lien against the property and the personal guarantees of the principal. Underwriting standards and credit analysis for SBLOCs should mirror those employed for direct loans.

The trustee receives periodic payments from the developer and then pays the bondholders their periodic interest payments and also pays the financial institution its letter-of-credit fee. In the event of a default by the developer, the trustee will draw upon the SBLOC to repay the bondholders. If such a default occurs, the issuing financial institution assumes the role of the lender for the project.

The structure of the transaction requires the bank issuing the SBLOC to assume virtually all of the risk. Because the purpose of these bonds is to encourage development, financially marginal projects, which would not be feasible under conventional financing, are often financed in this manner. The primary underwriting consideration is the ability of the securing property to service the debt. The debt-service-coverage calculations should include both the tax-free rate, if applicable, obtained through the revenue bonds and market interest rates. The operations of the securing property should also be monitored on an ongoing basis. If new construction is involved, the progress should be monitored and any cost overruns should be identified and addressed.

Renewal of SBLOCs

Although most SBLOCs contain periodic renewal features, the examiner must be aware that the bank cannot relieve itself from liability simply by choosing not to renew the SBLOC. Virtually all of the bond issues require a notice of nonrenewal before the expiration of the SBLOC. If such notice is received by the trustee, the trustee normally considers the notice an event of default and draws against the existing SBLOC. The bank should protect itself, therefore, by continuously monitoring both the project and the status of the bonds. Documentation should be maintained in the bank's file to substantiate the property's occupancy, its cashflow position, and the status of the bonds. In addition to the current status of interest payments, any requirements for a sinking fund that are contained in the bond indenture should also be monitored.

Some letters of credit are automatically renewable unless the issuing bank gives the beneficiary prior notice (usually 30 days). These letters of credit represent some additional risk because of the notification requirement placed on the bank. As noted above, proper monitoring and timely follow-up are imperative to minimize risk.

Without the benefit of a substantial guarantor or equity in the collateral, these SBLOCs present more than normal risk of loss. If the SBLOC is converted into an extension of credit, the loan will likely be classified substandard or worse. Protection against loss may be provided by a long-term lease from a major tenant of an industrial property or a lease from a housing authority with a governmental funding commitment or guaranty.

Classification of SBLOCs

It may be appropriate to adversely classify an SBLOC if draws under the SBLOC are probable and a well-defined credit weakness exists. For example, deterioration of the financial standing of the account party could jeopardize performance under the letter of credit and result in the requirement of payment to the beneficiary. Such a payment would result in a loan to the account party and could result in a collection problem, especially if the SBLOC was unsecured. If payment is probable and the account party does not have the ability to repay the institution, an adverse classification is warranted. FASB 5 requires that if a loss contingency is probable and can be reasonably estimated, a charge to income must be accrued. Refer to section 2060, "Classification of Credits," in this manual for procedures on SBLOC classification.

BANKER'S ACCEPTANCES

When the beneficiary presents a draft to the issuer in compliance with the terms of a commercial letter of credit, the method of honoring the draft is acceptance. The issuer will stamp the word "accepted" across the face of the draft, which makes the instrument negotiable. Thus, the institution upon which the draft is drawn converts what was originally an order to pay into an unconditional promise to pay. Depending on the terms specified in the letter of credit, payment of the draft can vary from sight to 180 days. There is a ready market for these instruments, because payment must be made at maturity by the accepting institution, whether or not it is reimbursed by its customer. These acceptances are readily negotiable, and a beneficiary may sell accepted time drafts to other financial institutions at a discount. Acceptances are governed by article 3 of the UCC, and any rights the parties have under acceptance are subject to the rules of that article. For further discussion of banker's acceptances, see section 7060, "International—Banker's Acceptances," and the Instructions for the Preparation of the Report of Condition and Income.

Participations in Banker's Acceptances

The following discussion refers to the roles of accepting and endorsing banks in banker's acceptances. It does not apply to banks purchasing other banks' acceptances for investment purposes. Banker's acceptances may represent either a direct or contingent liability of the bank. If the acceptance is created by the bank, it constitutes a direct liability that must be paid on a specified future date. The acceptance is also an on-balance-sheet, recognized liability. If a bank participates in the funding risk of an acceptance created by another bank, the liability is contingent and the item is carried off-balance-sheet. The financial strength and repayment ability of the accepting bank should be considered in analyzing the amount of risk associated with these contingent liabilities.

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

Call Report Treatment

For regulatory reporting purposes, the existence of such participations is not to be recorded on the balance sheet. Rather, both the accepting bank conveying the participation to others and the bank acquiring the participation from the accepting bank must report the amounts of such participations in the appropriate item in Schedule RC-L, Commitments and Contingencies. (The amount of participations in acceptances reported in Schedule RC-L by a member bank may differ from the amount of such participations that enter into the calculation of the bank's acceptances to be counted toward its acceptance limit imposed by section 13 of the Federal Reserve Act (12 USC 372). These differences are mainly attributable to participations in ineligible acceptances, to participations with ''uncovered'' institutions, and to participations that do not conform to the minimum requirements set forth in 12 CFR 250.163.)

NOTE-ISSUANCE AND REVOLVING UNDERWRITING CREDIT FACILITIES

The first note-issuance facility (NIF) was introduced in 1981. A NIF is a medium-term (five- to seven-year) arrangement under which a borrower can issue short-term paper. The paper is issued on a revolving basis, with maturities ranging from as low as seven days to up to one year. Underwriters are committed either to purchasing any unsold notes or to providing standby credit. Bank borrowing usually involves commercial paper consisting of short-term certificates of deposit and, for nonbank borrowers, generally promissory notes (Euronotes). Although NIF is the most common term used for this type of arrangement, other terms include the revolving underwriting facility (RUF) and the standby note-issuance facility (SNIF).

Another type of facility, a RUF, was introduced in 1982. A RUF is a medium-term revolving commitment to guarantee the overseas sale of short-term negotiable promissory notes (usually a fixed-spread over LIBOR) issued by the borrower at or below a predetermined interest rate. RUFs separate the roles of the medium-term risk-taker from the funding institutions (the short-term investors). RUFs and NIFs allow access to capital sources at interest rates considerably below conventional financing rates. The savings in interest cost are derived because the borrower obtains the lower interest costs prevailing in the short-term markets, while still retaining the security of longer term financing commitments. The notes issued under RUFs are attractive for institutional investors since they permit greater diversification of risk than the certificates of deposit of only one bank. Underwriters favor them because their commitments do not appear on the statement of financial condition. RUFs are usually structured for periods of four to seven years.

A RUF differs from a NIF in that it separates the functions of underwriting and distribution. With a RUF, the lead bank (manager or arranger) acts as the only placing agent. The arranger retains total control over the placing of the notes.

NIFs and RUFs are discussed further in the *Bank Holding Company Supervision Manual*.

GUARANTEES ISSUED

State member banks and foreign branches of U.S. banks are allowed to issue guarantees or sureties under certain circumstances. Such guarantees are to be reported as contingent liabilities in Schedule RC-L. Refer to section 7090, ‘‘International—Guarantees Issued,’’ of this manual and to the call report instructions for further information.

ASSET SALES

The term ‘‘asset sales,’’ in the following context, encompasses the range of activities from the sale of whole loans to the sale of securities representing interests in pools of loans. Asset-sales programs entail establishing both a portfolio of assets that are structured to be easily salable and a distribution network to sell the assets. Most large banks have expended great effort in developing structures and standard procedures to streamline asset-sale transactions and continue to do so.

Asset sales, if done properly, can have a legitimate role in a bank's overall asset and liability management, and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a bank in diversifying its risks and improving its liquidity.

The benefits of a qualifying sale transaction are numerous. In particular, the sale of a loan reduces capital requirements. The treatment also enhances net income, assuming that the loan was sold for a profit.

Banks' involvement in commercial loan sales and in public issuance of mortgage and asset-backed securities has grown tremendously over the last decade. Banks are important both as buyers and sellers of whole loans, loan participations, and asset-backed securities. Banks also play important roles in servicing consumer receivables and mortgages backing securities and in providing credit enhancement to originators of primarily asset-backed securities.

Both whole loans and portions of loans are sold. Banks sell portions of loans through participation arrangements and syndication agreements.

Participations

A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests that would otherwise exceed lending limits, to diversify risk, and to improve liquidity by obtaining additional loanable funds. Participating banks are able to compensate for low local demand for loans or invest in large loans without their servicing burdens and origination costs. If not appropriately structured and documented, however, a loan participation can present unwarranted risks to both the seller and purchaser of the loan. Examiners should determine the nature and adequacy of the participation arrangement and should analyze the credit quality of the loan. For further information on participations, refer to section 2040, ‘‘Loan Portfolio Management,’’ in this manual.

Syndication

A syndication is an arrangement in which two or more banks lend directly to the same borrower pursuant to one loan agreement. Each bank in the syndicate is a party to the loan agreement and receives a note from the borrower evidencing the borrower's debt to that bank. Each participant in the syndicate, including the lead bank, records its own share of the participated loan. Consequently, the recourse issues and contingent liabilities encountered in a loan participation involving syndication are not normally an issue. However, many banks involved in syndicated transactions will sell some of their allotment of the facility through subparticipations. These subparticipations should be reviewed in the same manner as any other participation arrangement.

Asset Securitization

Banks have long been involved with asset-backed securities, both as investors in these securities and as sellers of assets within the context of the securitization process. In recent years, banks have increased their participation in the long-established market for those securities that are backed by residential mortgage loans. They have also expanded their securitizing activities to other types of assets, including credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables. See section 4030, “Asset Securitization,” for a detailed discussion of the securitization process.

Risks

Assets sold without recourse are generally not a contingent liability, and the bank should reflect on its books only that portion of the assets it has retained. In some instances, however, participations must be repurchased to facilitate ultimate collection. For example, a bank may sell the portion of a loan that is guaranteed by the Small Business Administration (SBA) and retain the unguaranteed portion and the responsibility for servicing the loan. In the event of a default, the holder of the guaranteed portion has the option to request the originating bank to repurchase its portion before presenting the loan to the SBA for ultimate disposition and collection. In addition, some banks may repurchase assets and absorb any loss even when no legal responsibility exists. It is necessary to determine management’s practice in order to evaluate the degree of risk involved. If management routinely repurchases assets that were sold without recourse, a contingency liability should be recognized. The amount of the liability should be based on historical data.

Contingent liabilities may also result if the bank, as the seller of a loan without recourse, does not comply with provisions of the agreement. Noncompliance may result from a number of factors, including failure on the part of the selling institution to receive collateral and/or security agreements, obtain required guarantees, or notify the purchasing party of default or adverse financial performance by the borrower. The purchaser of a loan may also assert claims that the financial information, which the purchaser relied on when acquiring the loan, was inaccurate, misleading, or fraudulent and that the selling bank was aware of the deficiencies. Therefore, a certain degree of risk may in fact be evident in assets allegedly sold without recourse. Examiners need to be mindful of this possibility and its possible financial consequences on the bank under examination.

Banks also face credit, liquidity, and interest-rate risk in the period in which they accumulate the assets for sale. Especially in mortgage banking activities, the need to carefully monitor interest-rate risk in the “pipeline” represents one of the significant risks of the business. Sellers of participations also face counterparty risk similar to that of a funding desk, because the loan-sales operation depends on the ongoing willingness of purchasers to roll over existing participations and to buy new ones. In addition, many banks sell loans in the secondary market but retain the responsibility for servicing the loans.

Accounting Issues

For regulatory reporting purposes, some transactions involving the “sale” of assets must be reported as financing transactions (that is, as borrowings secured by the assets “sold”), and others must be reported as sales of the assets involved. The treatment required for any particular transfer of assets depends on whether the “seller” retains risk in connection with the transfer of the assets. In general, to report the transfer of assets as a sale, the selling institution must retain no risk of loss or obligation for payment of principal or interest.

All recourse arrangements should be documented in writing. If a loan is sold with recourse back to the seller, the selling bank has, in effect, retained the full credit risk of the loan, and its lending limit to the borrower is not reduced by the amount sold. Loans sold with recourse are to be treated as borrowings of the selling bank from the purchasing bank. Examiners should consider asset sales subject to formal or informal repurchase agreements (or understandings) to be sales "with recourse" regardless of other wording in the agreement to the contrary.

In determining the true recourse nature of an asset sale, examiners must determine the extent to which the credit risk has been transferred from the seller to the purchaser. In general, if the risk of loss or obligation for payments of principal or interest is retained by, or may ultimately fall back upon, the seller or lead bank, the transaction must be reported by the seller as a borrowing from the purchaser and by the purchaser as a loan to the seller. Complete details on the treatment of asset sales for purposes of the report of condition and income are found in the glossary of the Instructions for the Preparation of the Report of Condition and Income under the entry "sales of assets."

OTHER OFF-BALANCE-SHEET ACTIVITIES AND CONTINGENT LIABILITIES

Banks often provide a large number of customer services, which normally do not result in transactions subject to entry on the general ledger. These customer services include safekeeping, the rental of safe deposit boxes, the purchase and sale of investments for customers, the sale of traveler's checks, the sale of U.S. Savings Bonds, collection services, federal funds sold as agent, operating leases, and correspondent bank services. It is the bank's responsibility to ensure that collateral and other nonledger items are properly recorded and protected by effective custodial controls. Proper insurance must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. Failure to take these protective steps may lead to contingent liabilities. In addition, pending litigation in which the bank is a defendant could expose the bank to substantial risk of loss. Refer to section 4000, "Other Examination Areas," in this manual for further information.

Banks often enter into operating leases as lessees of buildings and equipment. The arrangements should be governed by a written lease. For a material lease, the examiner must determine whether the lease is truly an operating lease or if it is a capitalized lease pursuant to FASB 13. Capitalized leases and associated obligations must be recorded on the books of the bank in accordance with FASB 13 and the instructions for the preparation of the Report of Condition and Income. Refer to the instructions for the call report and to section 2190, "Bank Premises and Equipment," in this manual for further information about capitalized leases.

While operating leases do not affect the bank's capital ratios, the costs of an operating lease may have a material effect upon the earnings of the bank. Moreover, operating leases may involve other responsibilities for the bank, and the bank's failure to perform these responsibilities may ultimately result in litigation and loss to the bank. The examiner must be cognizant of the requirements imposed on the bank by its leasing arrangements.

Some banks purchase federal funds from smaller correspondent banks as agent. This off-balance-sheet activity is more fully discussed in section 2030, "Bank Dealer Activities," in this manual.

Examination Objectives

Effective date November 1995

1. To determine if policies, practices, procedures, and internal controls regarding contingent claims from off-balance-sheet credit activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the off-balance-sheet credit activities for credit quality and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

This section provides supervisory and accounting guidance for examiners to use in their examination and review of a bank's creation and use of loan participation agreements. Additional guidance, research, and information on loan participations and loan participation agreements will be developed and considered for future issuance and implementation.

A loan participation is an agreement that transfers a stated ownership interest in a loan to one or more other banks, groups of banks, or other entities. The transfer represents an ownership interest in an individual financial asset. The lead bank retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Banks should ensure that comprehensive participation agreements with originating institutions are in place for each loan facility before they consider purchasing any participating interest.

Many banks purchase loans or participate in loans originated by others. In some cases, such transactions are conducted with affiliates, groups of banks, or members of a chain-banking organization. Alternatively, a purchasing bank may also wish to supplement its loan portfolio when loan demand is weak. In still other cases, a bank may purchase or participate in a loan to accommodate another unrelated bank with which it has established an ongoing business relationship.

Purchasing or selling loans, if done properly, can have a legitimate role in a bank's overall asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities help a bank diversify its risks and improve its liquidity.

BOARD POLICIES ON LOAN PARTICIPATIONS

Banks should have sufficient board-approved policies in place that govern their loan participation activities. At a minimum, the policy should include (1) the requirements for entering into a loan participation agreement, (2) limits for the aggregate amount of loans purchased from and sold to an outside source, (3) limits of all loans purchased and sold, (4) limits for the aggregate amount of loans to particular industries, (5) comprehensive participation agreements with originating banks, (6) complete analysis and documentation of the credit quality of obligations purchased, (7) an analysis of the value and lien status of the collateral, (8) appraisal guidelines, (9) the maintenance of full independent credit information on the borrower throughout the term of the loan, (10) guidelines for the timely transfer of all financial and nonfinancial credit information to participant banks, and (11) collection procedures.

LOAN PARTICIPATION AGREEMENT

A loan participation agreement may enable a smaller bank (the lead bank or transferor) to originate a large loan in excess of its legal lending limit. Participating banks that have an ownership interest are able to offset low local loan demand or invest in large loans without the burden of servicing the loan or incurring origination costs. A loan participation agreement may also allow the originating bank to facilitate and grant a larger loan without causing it to have a concentration of credit (i.e., enabling risk diversification) or an impairment of its liquidity position. The participation agreement should contain provisions that require the originating bank to transfer, in a timely manner, all financial and nonfinancial credit information to the participant banks upon the loan's origination and throughout the term of the loan. The agreement should specify the allocation of payments, losses, and expenses. It should also state that a participating bank has the right to perform its own independent review of the transaction. The agreement should contain no language indicating that the lead bank is a "lender" or that a participating bank is a "borrower." The purchase of loan participations without a comprehensive agreement could be viewed as an unsafe and unsound banking practice.

ACCOUNTING FOR LOAN PARTICIPATIONS

A loan participation agreement is usually structured to allow the participation transaction to receive sale treatment of a portion of the loan by the originating bank even though the participation agreement may restrict the purchaser when reselling its interest in the loan, subject to certain conditions.[1] Sale treatment is achieved by structuring the loan participation agreement so that interests sold to a purchaser meet the definition of a "participating interest" and the transaction satisfies all conditions for transfer of control over the interests. In general, FAS 166 (paragraph 8B) briefly defines a participating interest as a portion of a financial asset that

1. conveys proportionate ownership rights with equal priority to each participating interest holder.
2. involves no recourse (other than standard representations and warranties) to, or subordination by, any participating interest holder.
3. does not entitle any participating interest holder to receive cash before any other participating interest holder.

A transfer of a participating interest in an entire financial asset in which the transferor surrenders control over those interests is to be accounted for as a sale if and only if *all the following conditions* are met:

1. The transferred financial assets have been isolated from the transferor—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership.[2]
2. Each purchaser has the right to pledge or exchange the interests it received, and no condition both constrains the purchaser from taking advantage of its right to pledge or exchange and provides more than a trivial benefit to the transferor.
3. The transferor does *not* maintain effective control over the interests.[3]

STRUCTURING THE LOAN PARTICIPATION AGREEMENT

The written participation agreement should consider contingent events such as a defaulting borrower, the lead bank becoming insolvent, or a party to the participant arrangement that is not performing as expected. The agreement should clearly state the limitations the originator or participants impose on each other and any rights that the parties retain. The participation agreement should clearly include

- the obligation of the lead bank to furnish timely credit information and to notify the parties of significant changes in the borrower's status;
- a requirement that the lead bank consult with the participants prior to any proposed change to the loan, guarantee, or security agreements, or taking any action when the borrower defaults;
- the lead bank's and participants' specific rights if the borrower defaults;
- the resolution procedures to be followed when the lead bank or participants
  - do not agree on the procedures to be taken when the borrower defaults and/or;
  - have potential conflicts when the borrower defaults on more than one loan;
- provisions for terminating the agency relationship between the lead bank and the participants upon events such as insolvency, breach of duty, negligence, or misappropriation by one of the parties to the agreement.

1. Three sale recognition conditions denote the transferor's surrender of control under Financial Accounting Standards (FAS) 166, "Accounting for Transfers of Financial Assets" (an amendment of FAS 140). Those conditions must be met in order for the originator (transferor) to account for the transfer of the financial assets to the participating transferee as a sale. When a loan participation is accounted for as a sale, the seller (transferor) removes the participated interest in the loan from its financial statements. FAS 166 applies to both the transferor (seller) of the participated assets and the transferee (purchaser). (See the complete text of FAS 166 (paragraphs 8B and 9) that defines a "participating interest" and the conditions for sale recognition). See also the reporting instructions for the FFIEC Consolidated Reports of Condition and Income (FFIEC 031) (bank Call Report).

2. Transferred financial assets are isolated in bankruptcy or other receivership only if the transferred financial assets would be beyond the reach of the powers of a bankruptcy trustee or other receiver for the transferor or any of its consolidated affiliates included in the financial statements being presented.

3. Examples of a transferor's effective control over the transferred financial assets include (a) an agreement that both entitles and obligates the transferor to repurchase or redeem the financial asset (or its third-party beneficial interests) before its maturity, (b) an agreement that provides the transferor with both the unilateral ability to cause the holder to return specific financial assets and a more-than-trivial benefit attributable to that ability, other than through a cleanup call, or (c) an agreement that permits the transferee to require the transferor to repurchase the transferred financial assets at a price that is so favorable to the transferee that it is probable that the transferee will require the transferor to repurchase them.

Some participation agreements may allocate payments using a method other than a pro rata sharing based on each participant's ownership interest. The first principal payment could be applied based on the participant's ownership interest while the remaining payments would be applied according to the lead bank's ownership interest. In this situation, the participation agreement should specify that if a borrower defaults, the participants would share subsequent payments and collections in proportion to their ownership interest at the time of default.[4]

A participation agreement may provide that the lead bank, as the originating lender, allow a participating bank to resell, but the lead bank reserves the right to call at any time from whoever holds the ownership interest. The lead bank can then enforce the call option by cutting off or restricting the flow of interest at the call date.[5] In this situation, the lead bank, as originating lender, has retained effective control over the participation; such a call option precludes sale accounting treatment by the transferor. The transaction, therefore, should be accounted for as a secured borrowing.

INDEPENDENT CREDIT ANALYSIS

A bank that acquires a loan participation should regularly perform a rigorous credit analysis on its loan participation as if it had originated the loan. Due to the indirect relationship that a participating bank has with a borrower, it may be difficult for the participating bank to receive timely credit information to allow it to conduct a comprehensive credit analysis of the transaction. However, the participating bank should not rely solely on the lead bank's credit analysis. It should gather all available relevant credit information, including the details on the collateral's value (for example, values determined by an independent appraisal or an evaluation), lien status, loan agreements, and the loan's other participation agreements that existed prior to making its commitment to acquire the loan participation. A participating bank also should reach an agreement with the loan originator (transferor) that it will provide ongoing, complete, and timely credit information about the borrower. It is important for the participating banks to maintain current and complete records on their loan participations. The absence of such information may indicate that the bank did not perform the necessary due diligence prior to making its decision to acquire the loan participation. During the life of the loan participation, the bank should monitor the loan's servicing and repayment status.

4. This is *not* a participating interest—no sale.

5. The cash flows from a loan participation agreement, except servicing fees, should be divided in proportion to the third parties' participating interests.

SALES OF LOAN PARTICIPATIONS IN THE SECONDARY MARKET

If a bank has a concentration in loan participations, it may be possible for it to sell its participating interests in the secondary market to reduce its dependence on an asset group. If the bank is not large enough to participate in the secondary market, an alternative might be to sell loans without recourse to a correspondent bank that also desires to diversify its loan portfolio.

SALE OF LOAN PARTICIPATIONS WITH OR WITHOUT THE RIGHT OF RECOURSE

The parties to a participation agreement (those having a participating ownership interest) generally may have *no recourse* to the transferor or to each other even though the transferor (e.g., the originating lender) continues to service the loan. No participant's interest should be subordinate to another. Some loan participation agreements, however, may give the seller a contractual right to repurchase the participated loan interest for purposes of working out or modifying the sale. When the seller has the right to repurchase the participation, it may provide the seller with a call option on a specific loan participation asset. If the seller's right to repurchase precludes the seller from recognizing the transaction as a sale, the transaction should be accounted for as a secured borrowing.

SALES OF 100 PERCENT PARTICIPATIONS

Some loan participation agreements may be structured so that the transferor (lead bank) sells the entire underlying loan amount (100 percent) to the agreement's participants. If participation agreements are not structured properly they can pose unnecessary and increased risks (for example, legal, compliance, or reputational risks) to the originator and the participants. The lead bank, as originator, would have no ownership in the loan. Such agreements should therefore clearly state that the loan participants are participating in the loan and that they are not investing in a business enterprise. The policies of a bank engaged in such loan participation agreements should focus on safety and soundness concerns that include

- the program's objectives
- the plan of distribution
- the credit requirements that pertain to the borrower—the originating bank should structure 100 percent loan participation programs only for borrowers who meet the originating institution's credit requirements
- the program participant's accessibility to the borrower's financial information (as authorized by the borrower)—the originating bank should allow potential loan participants to obtain and review appropriate credit and other information that would enable them to make an informed credit decision.

PARTICIPATION TRANSACTIONS BETWEEN AFFILIATES

Banks should not relax their credit standards when participation agreements involve affiliated insured depository institutions. Such agreements must be structured to comply with sections 23A and 23B of the Federal Reserve Act (FRA) and the Board's Regulation W. The Federal Reserve has determined that in certain very limited circumstances the purchase or sale of a participation agreement may be exempt from these provisions.

Transfer of Low-Quality Assets

In general, a bank cannot purchase a low-quality asset, including a loan participation from an affiliate. Section 23A of the FRA provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[6] Section 223.15 of the Board's Regulation W provides an exception from the prohibition on the purchase of a low-quality asset by a member bank from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20-day post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

CONCENTRATIONS OF CREDIT INVOLVING LOAN PARTICIPATIONS

Banks should avoid purchasing loans that generate unacceptable credit concentrations. Such concentrations may arise solely from the bank's purchases, or they may arise when loans or purchased participations are aggregated with loans originated and retained by the purchasing bank. The extent of contingent liabilities, holdbacks, reserve requirements, and the manner in which loans will be handled and serviced should be clearly defined. In addition, loans purchased from another source should be evaluated in the same manner as loans originated by the bank itself. Guidelines should be established for the type and frequency of credit and other information the bank needs to obtain from the originat-

6. 12 USC 371c(a)(3).

ing institution to keep itself continually updated on the status of the credit. Guidelines should also be established for supplying complete and regularly updated credit information to the purchasers of loans originated and sold by the bank.

LOAN PARTICIPATIONS AND ENVIRONMENTAL LIABILITY

Environmental risk represents the adverse consequences that result from generating or handling hazardous substances or from being associated with the aftermath of contamination. Banks may be indirectly liable via their lending activities for the costs resulting from cleaning up hazardous substance contamination. Banks need to be careful that their actions making, administering, and collecting loans—including assessing and controlling environmental liability—cannot be construed as taking an active role in the management or day-to-day operations of a borrower's business. Such actions could lead to potential liability under the Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA). Banks that originate loans to borrowers through loan participation agreements could be transferring environmental risk and liability to the holders of participations, thus making them susceptible to such losses. The originating banks should establish and follow policies and procedures designed to control environmental risks. See section 2140.1 (the "Environmental Liability" subsection) for a more detailed discussion on ways banks can protect themselves as lenders, and their loan participation agreement holders, from environmental liability.

RED FLAG WARNING SIGNALS

The following conditions may indicate that there are significant problems with the management of the bank's loan participation portfolio:

1. the absence of formal loan participation policies.
2. the absence of any formal participation agreement.
3. the absence of credit evaluations and independent credit analysis.
4. the absence of complete loan documentation.
5. a higher volume of loan participations when compared to the volume of other loans in the bank's loan portfolio.
6. missing loan participation agreements and documentation which should denote the rights and responsibilities of all participants.
7. the existence of numerous disputes or disagreements among the participants regarding
   a. the receipt of payment(s) in accordance with the participation agreements,
   b. documentation requirements, or
   c. any other significant aspects of the bank's loan participation transactions.
8. the originating bank is making loan payments to loan participation acquirers without receiving reimbursement by the original borrower.

1. To ascertain if the bank engages in the purchase or sale of loans via loan participation agreements.
2. To determine if the bank's lending policy
   a. places limits on the amount of loan participations originated, purchased, or sold based on any one source or in the aggregate;
   b. has set credit standards for the bank's borrowers requesting loans as well as third parties acquiring loan participations from the bank as originator;
   c. requires the same credit standards for loan participations as it does for other loans;
   d. sets the amount of contingent liability, holdback (retained ownership), and the manner in which the loan should be serviced; or
   e. requires complete loan documentation for loan participations.
3. To assess the impact of any concentrations of credit to a borrower, or in the aggregate, that arise from loans involved in loan participation agreements.
4. To determine if there are any informal repurchase agreements that exist between loan participation acquirers that are designed to circumvent the originating bank's legal lending limits, disguise delinquencies, and avoid adverse classifications.
5. To determine whether the bank's financial condition is compromised by assessing the impact of the bank's loan participations with its affiliates.
6. To ascertain whether the bank's loan participation transactions with affiliates are in compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
7. To determine if there are disputes between the bank as originator of loan participations and its participants. To determine, if possible, if any loan participations have been adversely classified by examiners, including examiners from other supervisory agencies (includes loan participations held by the other institutions).

These examination procedures are designed to ensure that originated loans that were transferred via loan participation agreements or certificates to state member banks, bank holding companies, nonbank affiliates, or other third parties were carefully evaluated. The examination procedures also instruct examiners to determine if the asset transfers were carried out to avoid or circumvent classification and to determine the effect of the transfers on the bank's financial condition. In addition, the procedures are designed to ensure that the primary regulator of another financial institution involved in the asset transfer is notified.

1. Review the board of directors' or their designated committees' policies and procedures governing how loan participation agreements and activities are created, transacted, and administered. Refer to section 2045.1 for the minimum items that should be included in board-approved policies on loan participation activities.
2. Determine if managerial reports provide sufficient information relative to the size and risk profile of the loan participation portfolio and evaluate the accuracy and timeliness of reports produced for the board and senior management.
3. For loan participations held (either in whole or in part) with another lending institution, review, if applicable,
   - participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
   - loan documentation to determine if it meets the bank's underwriting procedures (that is, the documentation for loan participations should meet the same standards as the documentation for other loans the bank originates);
   - the transfer of loans immediately before the date of the examination to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current examination; and
   - losses to determine if they are shared on a pro rata or other basis according to the terms of the participation agreement.
4. Check participation certificates or agreements and records to determine whether the parties share in the risks and contractual payments on a pro rata or other basis.
5. Determine if loans are purchased on a recourse basis and that loans are sold on a nonrecourse basis.
6. Ascertain that the bank does not buy back or pay interest on defaulted loans in contradiction of the underlying participation agreement.
7. Compare the volume of outstanding originated or purchased loans that were issued in the form of loan participations with the total outstanding loan portfolio.
8. Determine if the bank has sufficient expertise to properly evaluate the volume of loans originated or purchased and sold as loan participations.
9. Based on the terms of the loan participation agreements, review the originator's distribution of the borrower's payments received to those entities or persons owning interests in the loan participations. Ascertain if the agreement's recourse provisions may require accounting for the transactions as a secured borrowing rather than as a sale.
10. Determine if loans are sold primarily to accommodate credit overline needs of customers or to generate fee income.
11. Determine if loans are purchased or sold to affiliates or other companies in a chain-banking organization or a commonly owned group of banks; if so, determine whether the purchasing companies are given sufficient information to properly evaluate the credit. (Section 23A of the Federal Reserve Act and the Board's Regulation W prohibit transfers of low-quality assets between affiliates. See section 4050.1, "Bank-Related Organizations.")
12. Investigate any situations in which assets were transferred before the date of examination:
    a. Determine if any were transferred to avoid possible criticism during the examination.
    b. Determine whether any of the loan participations transferred were nonperforming at the time of transfer, classified during the previous examination, or transferred for any other reason that may

cause the loans to be considered of questionable quality.

13. Review the bank's policies and procedures to determine whether loan participations purchased by the bank are required to be given an independent, complete, and adequate credit evaluation. If the bank is a holding company subsidiary or a member of a chain-banking organization or commonly owned group of banks, review asset participations sold to affiliates or other known members of the chain or group of banks to determine if the asset purchases were supported by an *arm's-length* and *independent* credit evaluation.
14. Determine that any assets purchased by the bank were properly reflected on its books at fair market value at the time of purchase.
15. Determine that transactions involving transfers of low-quality assets to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and the holding company affiliate.
16. If poor-quality assets were transferred to another financial institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank's appropriate staff will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable,
    - name of originating and receiving institutions;
    - type of assets involved;
    - date (or dates) of transfer;
    - total number and dollar amount of assets transferred;
    - status of the assets when transferred (e.g., nonperforming, classified, etc.); and
    - any other information that would be helpful to the other regulator. Ascertain whether the bank manages not only the risk from individual participation loans but also portfolio risk.
17. Find out if management develops appropriate strategies for managing concentration levels, including the development of a contingency plan to reduce or mitigate concentrations during adverse market conditions (such a plan may include strategies involving not only loan participations, but also whole loan sales). Find out if the bank's contingency plan includes selling loans as loan participations.
18. Ascertain if management periodically assesses the marketability of its loan participation portfolio and evaluates the bank's ability to access the secondary market.
19. Verify whether the bank compares its underwriting standards for loan participations with those that exist in the secondary market.

1. Under what circumstances are loans participated?
2. Who determines the type of loans that may be participated? Does the bank have policies in that regard? Are credit standards included in the lending policy for purchased loan participations, and does the policy require complete loan documentation and independent credit and collateral evaluation or appraisal?
3. Does the lending policy place lending limits on the amount of loan participations purchased from any one source, and does it place an aggregate limit on such loans?
4. Are low-quality loans allowed to be participated?
5. What is the volume and frequency of inter-institution transactions involving loan participations?
6. Does the bank have accounting policies to ensure the appropriate treatment of loan participations as either sales or secured borrowings?

INTRODUCTION

A concentration exists when extensions of credit or other obligations possess similar risk characteristics. Typically, loans to related groups of borrowers, loans collateralized by a single security or securities with common characteristics, and loans to borrowers with common characteristics within an industry have been included in homogeneous risk groupings when assessing asset concentrations. Furthermore, a concentration may include the aggregate of all types of credit (e.g., loan product) to or investment in a particular homogeneous risk grouping.

While the size of a concentration does not necessarily determine the risk, a bank's asset quality, earnings, or capital can be disproportionally affected by a single or localized economic event or market conditions if the bank holds significant asset concentrations. Therefore, a bank's risk-management system needs to identify, measure, monitor, and control concentrations in a bank's loan portfolios and investments.

LEGAL LENDING LIMITS AND REGULATORY CONSIDERATIONS

Limitations imposed by the various state and federal legal lending limits are intended to prevent an individual or a relatively small group from borrowing an undue amount of the bank's resources and to safeguard the bank's depositors by spreading the loans among a relatively large number of persons engaged in different businesses. However, lending limits alone are not sufficient to prevent and control concentrations of credit.

The Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR 208 appendix D-1 for state member banks) state that a depository institution should establish and maintain prudent credit underwriting practices that take adequate account of concentration of credit risk. Further, an insured depository institution should establish and maintain a risk-management system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. In establishing and maintaining its risk-management system, the institution should, among other things, consider the size and potential risks of material asset concentrations.

The real estate lending standards in the Board's Regulation H require each state member bank to adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate.[1] In terms of governance, a bank's real estate lending policies must be consistent with safe and sound banking practices; appropriate to the size of the institution and the nature and scope of its operations; and reviewed and approved by the bank's board of directors at least annually. The real estate lending policies outlined in 12 CFR 208.51 should consider the Interagency Guidelines for Real Estate Lending Policies (12 CFR 208, appendix C). The Interagency Guidelines for Real Estate Lending Policies state that in managing its loan portfolio, the institution should consider both internal and external factors in the formulation of its loan policies and strategic plan. This includes the need to avoid undue concentrations in risk.

In addition, the Board's Regulation F (12 (12 CFR 206) addresses exposure that may arise from a bank's relationship with its correspondents. Regulation F states that a bank must establish policies and procedures that take into account credit and liquidity risks, including operational risks, in selecting correspondents and in terminating those relationships. At least annually, these policies and procedures should be reviewed and approved by the bank's board of directors. For more information, see this manual's sections on "Interbank Liabilities" and "Correspondent Concentration Risks."

TYPES OF CREDIT CONCENTRATIONS

There are numerous approaches for determining concentrations within a loan portfolio. In evaluating a potential concentration, a bank needs to determine the key factors germane to the credit portfolios.

1. 12 CFR 208.51.

Commercial Real Estate (CRE) Credit Concentrations

Concentrations in commercial real estate (CRE) loans are particularly noteworthy given its historical volatility and role in bank failures.[2] Banks may view a CRE loan as a product, which would include all transactions secured by commercial real estate. Alternatively, banks may also take an "industry" view, which would include only those CRE loans where the primary source of repayment is sale or refinancing of commercial real estate or collection of lease and rental payments of the property. A CRE loan pool may be further segmented by other factors such as geography, property use, tenant concentrations, risk rating, or credit structure (for instance, fixed or variable interest rate).

Banks with weak risk management and high CRE credit concentrations are exposed to a greater risk of loss and failure. Therefore, banks with CRE credit concentration should have appropriate risk-management practices in place to manage their risk exposure.[3]

Other Common Loan Portfolio Concentrations

Other concentrations that are commonly identified in a loan portfolio include the following:

- Loans to a group of borrowers, perhaps unrelated, predicated on the collateral support afforded by a debt or equity issue of a corporation. Regardless of whether the issuing entity is a publicly traded company or a closely held enterprise, a concentration may exist in the underlying collateral.
- Loans that are dependent on a particular agricultural crop or livestock herd. Banking institutions located in farming, dairying, or livestock areas may grant substantially all their loans to individuals or concerns engaged in and dependent on the agricultural industry. Concentrations of agricultural lending activity are commonplace and may be necessary if these banks are to adequately serve the needs of their communities.[4]
- Reserve-based lending, which is a type of financing where a loan is secured by the reserves of oil and gas of a borrower and repaid primarily using the proceeds from the future sale of encumbered oil or gas reserves. Concentrations can occur in any one well, reservoir, field, or producing area. For more information on the management of concentrations in energy lending, see this manual's section, "Energy Lending—Reserve-Based Loans"
- The aggregate amount of interim construction loans that do not have firm, permanent takeout commitments. In the event that permanent financing is not obtainable, the bank will have to continue financing the real estate property until the borrower sells the property or obtains permanent financing from another lender. This longer term financing subjects the bank to additional liquidity and possibly interest rate risks as well as to market and economic risks associated with the real estate property.
- Loans to groups of borrowers who handle a product from the same industry or economic sector. Although the borrowers may appear to be independent from one another, their financial conditions may be affected similarly if a slowdown occurs in their economic sector.
- Loans that are originated in geographic areas that are economically driven by a certain industry or dominated by one or only a few business enterprises. In these situations, banks may extend a substantial amount of credit to these companies and to a large percentage of the companies' employees. If economic or other events cause the enterprise's operations to slow down or stop, heavy unemployment may result as there may be limited job opportunities in the area.
- Loans that are extended to other financial institutions, including, but not limited to, due from accounts, federal funds sold, investments, net current exposure of derivatives contracts, and direct or indirect loans. For more information, see SR-10-10, "Interagency Guidance on Correspondent Concentration Risk," and this manual's section, "Correspondent Concentration Risks."
- Retail loan products, including, but not limited to, credit cards, home equity lines of credit, home equity loans, residential first mortgages, auto loans, boat loans, and manu-

2. For more information, see SR-15-17, "Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending."

3. See also this manual's section, "Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices."

4. See also this manual's section, "Agricultural Loans."

factured housing loans. In these cases, loan product features (e.g., target market, purpose, documentation, underwriting criteria, or repayment expectations) constitute the common characteristics and sensitivities of the loans. These pools may be further segmented by other factors, such as direct or indirect loans, vintage, credit scores, or loan-to-value ratios.

RISK MANAGEMENT OF ASSET CONCENTRATIONS

The key risk-management objective for credit concentrations is to identify pools of transactions that may act like a single, correlated exposure. The sophistication of a bank's risk-management processes should be appropriate to the size as well as the level and nature of concentrations and the associated risk to the bank. A bank's risk-management framework should effectively identify, monitor, and control concentration risk.

The board of directors is responsible for establishing the bank's strategic plan, including the level of assumed risk. If the bank has significant credit concentration risk, its strategic plan should address the rationale for such a concentration in relation to its overall growth objectives, financial targets, and capital plan. A bank's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate relevant credit factors. When a bank has a credit concentration, the establishment of sound lending policies becomes even more critical to promote credit quality in its credit portfolio.

A strong management information system (MIS) is key to effective portfolio management. The sophistication of MIS will necessarily vary with the size and complexity of the credit portfolio and level and nature of existing or planned concentrations. Effective MIS produces timely, comprehensive, and accurate data. MIS should provide management with sufficient information to identify, measure, monitor, and manage concentration risk. This includes meaningful information on portfolio characteristics that is relevant to the bank's lending strategy, underwriting standards, and risk tolerances. A bank should assess periodically the adequacy of MIS in light of changes in its credit portfolio's size, risk profile, and complexity.

Banks that have effective internal controls to manage and reduce excessive concentrations over a reasonable period of time need not automatically refuse credit to sound borrowers because of their particular industry or geographic location. Banks should appropriately incorporate analytical information (such as scenario analysis results, if conducted) in establishing concentration limits and managing concentration risks.

Furthermore, a bank may be able to reduce the risks associated with concentrations through strengthening the loan terms in an individual credit. For example, the bank may be able to obtain additional collateral, government guarantees, crop insurance backed by government agencies, or private insurance arrangements for loans or asset pledging. In the event of deterioration, the bank's position would be strengthened because the additional collateral or guarantees provide a cushion against any losses.

When concentration levels have been built up over an extended period, a bank needs time, in some cases several years, to achieve a more balanced and diversified portfolio mix. Given the bank's trade area, lack of economic diversity, or geographic location, reducing the existing concentration in the near term may be impossible. If a concentration does exist, the bank should have adequate systems and controls for reducing undue or excessive concentrations in accordance with a prudent plan. Strong credit policies and loan administration standards should provide adequate control for the risks associated with new loans in a loan portfolio with a high risk concentration. The bank should also maintain adequate capital to protect the bank while its portfolio is being restructured. For identified asset concentrations, bank management should be aware of not only the current market and economic trends for a particular asset concentration as well as future prospects.

Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. If the concentrations compromise the safety and soundness of the institution, management is normally expected to develop a plan to reduce the asset concentration that is realistic, prudent, and achievable in view of the particular circumstances and market conditions.

Alternatives for Reducing Credit or Asset Concentrations

As noted above, sometimes credit concentration can become so significant that, if the common factor influencing the credit portfolio deteriorates sufficiently, even a portfolio of well underwritten loans can suffer losses and reduce an institution's capital. This possibility underscores why the control and management of concentration risk is so important. To manage a credit or asset concentration, a bank may consider the following actions.

Increased holdings of capital. To compensate for the additional risk that may be associated with an asset concentration, a bank may elect to maintain a higher capital ratio than would be required under the appropriate capital regulations. This additional capital would provide support in the event the concentration adversely affects the organization's financial position.

Increased allowance for credit losses. The bank may choose to factor credit concentrations into its determination of an adequate allowance for credit losses. Management should consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. As part of the loss estimation process, management should consider, among other things, the existence, growth, and effect of any concentrations of credit.

Loan participations. If a bank has a concentration, the bank may sell a portion of its loan portfolio in the secondary market to reduce its dependency on an asset group. If the bank is not large enough to participate in the secondary market, the bank might be able to sell loans, without recourse, to a correspondent bank that is also attempting to diversify its loan portfolio. For more information on loan participations, see this manual's section entitled, "Loan Participations, the Agreements and Participants."

Government guarantee programs. Another possible solution to reduce the risk associated with a loan concentration is for the bank to participate in loan programs that provide a government guarantee or insurance in the event the borrower defaults on a loan. Such programs provide the bank with the ability to offset a portion of its credit risk.

Modifying underwriting standards. Modifying underwriting standards to increase exposure to higher quality transactions or to diminish exposure to weaker borrowers. Concurrently, management can increase the level of oversight over credit underwriting while executing exit strategies from lower-quality relationships (e.g., increasing pricing or tightening terms and conditions).

Diversification of the loan portfolio. Banks can engage in activities or markets that are not likely to perform in a similar manner with its existing loan portfolios, considering its expertise in a market and loan products.

Modifying exposure limits or credit risk benchmarks. This can be accomplished by adjusting limits on loan commitments or outstanding balance on a line of credit, or tightening constraints on distribution by the bank's internal loan ratings/grades.

Buying credit derivative protection. For some banks, it may be appropriate to engage in default or total return swaps on an individual credit transaction or a loan pool.

SUPERVISORY CONSIDERATIONS FOR ASSESSING CONCENTRATIONS

Quantitative Considerations

Examiners should determine the existence of any credit concentrations at the bank and assess whether any concentrations of credit represent a hazard to the safety and soundness of the bank or violate applicable laws and regulations. Examiners should understand the activities that may heighten concentration risk, such as acute asset growth; increases in nonperforming assets; or changes to the bank's loan portfolio. As described in the this manual's section, "Earnings—Analytical Review of Income and Expense," examiners should reference the Uniform Bank Performance Report (UBPR) as well as the most recent financial statements and other related financial information in performing the analytical review of a bank. UBPR page 7B entitled, "Analysis of Concentrations of Credit" and provides percentages of certain bank assets by its capital. More specifically, the UBPR provides concentration information on residential and commercial real estate loans, construction and development lending, agricultural loans, commercial and industrial loans, and different types of leases.

For supervisory processes, examiners should evaluate a bank's credit concentration ratios to assess the size and potential risks of material credit concentrations posed to the bank's capital. In March 2020, the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (agencies) adopted a common approach for defining credit concentration ratios.[5] As of March 31, 2020, for banks that have adopted the Financial Accounting Standards Board's Accounting Standards Codification Topic 326, *Financial Instruments—Credit Losses* that implements the current expected credit losses (CECL) methodology, the agencies' examiners will calculate credit concentration ratios using

- tier 1 capital plus the allowance for credit losses attributed to loans and leases as the denominator.[6]

For institutions that have not adopted CECL, the agencies' examiners calculate credit concentration ratios using

- tier 1 capital plus the entire allowance for loan and lease losses as the denominator.

When determining and calculating concentrations, the amount of loan commitments and other off-balance-sheet risk items should be considered. This includes all types of loans, overdrafts, cash items, suspense resources, securities, leases, acceptances, advances, letters of credit, and all other items due to the bank as well as loans endorsed, guaranteed, or cosigned by related individuals and their related interests. A concentration of credit generally exists when an institution advances or commits economically related direct or indirect extensions of credit and contingent obligations to a person, entity, or affiliated group that, when aggregated, exceed 25 percent of the bank's capital, as defined above.

Qualitative Considerations

In addition to the quantitative assessment of bank concentration ratios, examiners should understand and evaluate the effectiveness of the internal policies, systems, and controls that a bank uses to monitor and manage the risk associated with asset concentrations. Examiners should determine whether the bank's MIS reports on credit concentrations are adequate and allow management to make informed decisions. Further, examiners should determine whether management followed established guidelines for concentrations, and if those guidelines align with the bank's risk appetite or strategic plan. If the

5. The agencies adopted this approach in response to changes in the regulatory capital requirements for some banking organizations after the implementation of the community bank leverage ratio (CBLR) rule (84 Fed. Reg. 61,776 (November 19, 2019)). As of March 31, 2020, qualifying community banking organizations (generally, depository institutions and depository institution holding companies with less than $10 billion in total consolidated assets that meet other qualifying criteria, including a leverage ratio of greater than 9 percent) that elect the CBLR framework are no longer required to report tier 2 capital. Tier 2 capital is a component of total capital, which has generally been the denominator in credit concentration ratios used for supervisory processes. See SR-20-8, "Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach."

6. The agencies have adopted final rules providing banks the option to phase in the day-one adverse effects on regulatory capital that may result from the adoption of the CECL accounting standard. See 84 Fed. Reg. 4222, February 14, 2019 and 85 Fed. Reg. 17,723, March 31, 2020. For banks that are phasing in the capital impact of implementing the CECL accounting standard, the denominator for concentration calculations is tier 1 capital plus allowance for loan and lease losses or allowance for credit losses adjusted for the amount of CECL phase in capital included in both allowance and tier 1 capital. As noted in 84 Fed. Reg. 4222, for purposes of determining whether a bank phasing in the capital impact of implementing the CECL methodology is in compliance with its regulatory capital requirements (including capital buffer and prompt corrective action requirements), the agencies will use the bank's regulatory capital ratios as adjusted by the CECL transition provision. Through the supervisory process, the agencies will continue to examine banks' credit loss estimates and allowance balances regardless of whether the bank has elected to use the CECL transition provision. In addition, the agencies may examine whether electing bank will have adequate amounts of capital at the expiration of their CECL transition provision period. After all banks have adopted the CECL methodology and have exited their CECL transition provision periods, it will no longer be necessary to adjust for the amount of CECL phase in capital included in both the allowance and tier 1 capital.

For the purposes of measuring concentrations at banks that are phasing in the adoption of the CECL accounting standard, examiners should evaluate the appropriateness of the amounts included in the denominator for the tier 1 capital calculation and confirm that the CECL transitioned amounts, if elected, plus the allowance for credit losses related to loans and leases have been excluded. To calculate the amount to be excluded from tier 1 capital, examiners should use the difference between "retained earnings" as reported on item 26.a of Schedule RC to the Call Report and "retained earnings" as reported on item 2 Schedule RC-R, Part I, to the Call Report. This resulting difference is the amount of retained earnings that should have been used to calculate tier 1 capital for purposes of measuring lending-related concentrations and should equal the retained earnings on the institution's balance sheet.

bank modified its strategic plans in a way that could increase concentration risk at the bank, examiners should assess whether the bank made the necessary modifications to concentration risk-management systems.

A bank should maintain adequate records that may be used to identify asset concentrations. The degree of sophistication of the reporting records will vary by the asset size of a bank. Regardless of the identification system used by the bank, examiners should verify the accuracy of listed concentrations in such reporting records, as well as the appropriateness of concentrations, during the examination.

Reporting Concentrations in the Report of Examination

As noted in the "Community Bank Supervision Process" section of this manual, examiners are to include a discussion on concentrations in the report of examination if the bank has materially deficient practices in managing concentrations. The report of examination should include a discussion of the appropriateness of risk-management practices regarding any materially significant concentrations of assets, liabilities, specific industries, and other categories, as applicable. If the bank has materially deficient practices in managing concentrations or has concentrations that compromise safety and soundness, the report of examination should address the bank's alternatives or plans for reducing concentrations. Further, examiners should comment on the ability to leverage the bank's internal concentration reporting when conducting the review and assessment of concentrations.

INTRODUCTION

This section will provide examiners with a fundamental understanding of secured and unsecured commercial and industrial loans, loan evaluation and coverage techniques, the key principles for assessing credit quality, minimum documentation standards for loan line sheets, and basic bankruptcy law, as well as an overview of sections 23A and 23B of the Federal Reserve Act and tie-in arrangements. Other sections of this manual discuss more specific types of lending.

The term "commercial and industrial loan" is commonly used to designate loans to a corporation, commercial enterprise, or joint venture that are not ordinarily maintained in either the real estate or consumer installment loan portfolios. Generally, commercial loans are the largest asset concentration of a state member bank, offer the most complexity, and require the greatest commitment from bank management to monitor and control risks. Proper management of these assets requires a clearly articulated credit-policy that imposes discipline and sound loan administration. Since lenders are subject to pressures related to productivity and competition, they may be tempted to relax prudent credit-underwriting standards to remain competitive in the marketplace, thus increasing the potential for risk. Examiners need to understand the unique characteristics of the varying types of commercial and industrial loans, as well as how to properly analyze their quality.

Commercial loans are extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial and industrial loans can vary widely depending on the purpose of loans made and market characteristics where the bank operates, most commercial and industrial loans will primarily be made in the form of a seasonal or working-capital loan, term business loan, or loan to an individual for a business purpose.

PRIMARY TYPES OF COMMERCIAL AND INDUSTRIAL LOANS

Seasonal or Working-Capital Loans

Seasonal or working-capital loans provide a business with short-term financing for inventory, receivables, the purchase of supplies, or other operating needs during the business cycle. These types of loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities, such as a retailer who relies heavily on a holiday season for sales or a manufacturing company that specializes in summer clothing. These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised revocable line of credit is a revocable commitment by the bank to lend funds up to a specified period of time, usually one year. Lines of credit are generally reviewed annually by the bank, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the bank has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually it has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit. Repayment of the loans is generally accomplished through conversion or turnover of short-term assets. Interest payments on seasonal loans are usually paid throughout the term of the loan, such as monthly or quarterly.

Seasonal or working-capital loans are intended to be repaid through the cash flow derived from converting the financed assets to cash. The structure of the loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, seasonal or working-capital facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. While this requirement is becoming less common, it provides the bank with proof that the borrower is not dependent on the lender for permanent financing. It is important to note, however, that an expanding business may not be able to clean up its facility since it may be increasing its current assets.

Analysis of Seasonal and Working-Capital Loans

The analysis of a seasonal loan is best accomplished by a monthly or quarterly review of a company's balance sheet and income statements to identify the peak and contraction phases of the business cycle. The lender should know when the peak and contraction phases are, and the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts. Repayments on the facility should also be consistent with the conversion of assets. If the borrower has other loan facilities at the bank, all credit facilities should be reviewed at the same time to ensure that the activity with the seasonal or working-capital facility is not linked to other loans in the bank. Projections of sources and uses of funds are also a valuable tool for reviewing a seasonal or working-capital line of credit and determining the sales cycle.

Quarterly balance-sheet and income statements are very helpful when a comparison is made with the original projections. Other helpful information can be obtained from a review of an aging of accounts receivable for delinquencies and concentrations, a current list of inventory, an accounts-payable aging, and accruals made during the quarter. This information can be compared with the outstanding balance of the facility to ensure that the loan is not overextended and that the collateral margins are consistent with borrowing-base parameters. A borrowing base is the amount the lender is willing to advance against a dollar value of pledged collateral; for example, a bank will only lend up to a predetermined specified percentage of total outstanding receivables less all past-due accounts more than a certain number of days delinquent. A borrowing-base certificate should be compiled at least monthly or more often during peak activity in the facility. When reviewing seasonal loans, examiners should remember that a bank relies heavily on inventory as collateral in the beginning of a company's business cycle and on receivables toward the end of the business cycle. However, in traditional working-capital loans, greater emphasis is usually placed on accounts receivable as collateral throughout the loan's tenure.

Normally, a bank is secured by a perfected blanket security interest on accounts receivable, inventory, and equipment and on the proceeds from the turnover of these assets. Well-capitalized companies with a good history of seasonal payout or cleanup may be exceptions. An annual lien search, however, would be prudent under this type of lending relationship to detect any purchase-money security interest that may have occurred during the business cycle.

The following are potential problems associated with working-capital and seasonal loans:

- *Working-capital advances used for funding losses.* A business uses advances from a revolving line of credit to fund business losses, including the funding of wages, business expenses, debt service, or any other cost not specifically associated with the intended purpose of the facility.
- *Working-capital advances funding long-term assets.* A business will use working-capital funds to purchase capital assets that are normally associated with term business loans.
- *Trade creditors not paid out at end of business cycle.* While the bank may be paid out, some trade creditors may not get full repayment. This can cause a strained relationship as unpaid trade creditors may be less willing to provide financing or offer favorable credit terms in the future. In turn, the business will become more reliant on the bank to support funding needs that were previously financed by trade creditors.
- *Overextension of collateral.* The business does not have the collateral to support the extension of credit, causing an out-of-borrowing-base situation. Examiners should review borrowing-base certificates to verify that coverage meets the prescribed limitations established by the bank's credit policy for the specific asset being financed.
- *Value of inventory declines.* If a business does not pay back the bank after inventory is

converted to cash or accounts receivable, the value of the inventory declines. Other causes of inventory devaluation include obsolescence; a general economic downturn; or, in the case of a commodity, market volatility. Declines in inventory value will commonly put a working-capital facility in an out-of-borrowing-base situation and require the excess debt to be amortized and repaid through future profits of the business.

- *Collectibility of accounts receivable declines.* The increasingly past-due status of accounts receivable or deteriorating credit quality of account customers both result in the noncollection of receivables. This can also cause an out-of-borrowing-base situation for the lending institution.
- *Working-capital advances used to fund long-term capital.* Funds may be inappropriately used to repurchase company stock, pay off subordinated debt holders, or even pay dividends on capital stock.

These situations may cause a loan balance to be remaining at the end of the business cycle. If this should occur, the bank generally has one of three options: (1) Require the unpaid balance to be amortized. This option is, however, dependent on the ability of the business to repay the debt through future profits. (2) Request the borrower to find another lender or require an infusion of capital by the borrower. This is not always a feasible option because of the probable weakened financial condition of the business and ownership under these circumstances. (3) Liquidate the collateral. Foreclosing on the collateral should only be executed when it becomes obvious that the business can no longer function as a going concern. The problem with this option is that once the bank discovers that the business is no longer a viable concern, realizing the full value of the collateral is in jeopardy. The need to resort to any of these options may prompt criticism of the credit.

Term Business Loans

Term business loans are generally granted at a fixed or variable rate of interest, have a maturity in excess of one year, and are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business. Term business loans involve greater risk than short-term advances because of the length of time the credit is extended. As a result of this greater risk, term loans are often secured. Loan interest may be payable monthly, quarterly, semiannually, or annually.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative covenants that place certain conditions on the borrower throughout the term of the loan. Generally, loan agreements substantially enhance a borrower/banker relationship because they encourage and promote more frequent communication between the parties. In affirmative covenants, the borrower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt coverage ratio, exceeding a maximum debt-to-equity ratio, or taking any action that may diminish the value of collateral or impair the collectibility of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by bank management.

Analysis of Term Business Loans

While a seasonal or working-capital loan analysis emphasizes the balance sheet, the analysis of term loans will focus on both the balance sheet and the income statement. Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the loan's contractual agreements. One of the most critical determinations that should be made when evaluating term debt is whether the term of the debt exceeds the useful life of the underlying asset being financed.

While cash flow of the business is the primary source of repayment for a term loan, a secondary source would be the sale of the underlying collateral. Often, if circumstances warrant a collateral sale, the bank may face steep discounts and significant expenses related to the sale. Examiners should carefully consider these issues when evaluating the underlying value of collateral under a liquidation scenario.

The following are potential problems associated with term business loans:

- The term of the loan is not consistent with the useful life of collateral.
- Cash flow from operations does not allow for adequate debt amortization, a fundamental problem that can only be solved by improved performance.
- The gross margin of the business is narrowing, which requires the business to sell more product to produce the same gross profit. Higher sales volume could require more cash for expansion of current assets, leaving less cash for debt amortization. This situation is a common by-product of increased competition.
- Sales are lower than expected. In the face of lower sales, management is unable or unwilling to cut overhead expenses, straining cash flow and resulting in diminished debt-servicing ability.
- Fixed assets that are financed by term loans become obsolete before the loans are retired, likely causing the value of underlying collateral to deteriorate.
- The business's excess cash is spent on higher salaries or other unnecessary expenses.
- The payments on term debt have put a strain on cash flow, and the business is unable to adequately operate or allow natural expansion.
- The balance sheet of the business is weakening. The overall financial condition of the business is deteriorating because of poor performance or unforeseen occurrences in the industry.

SECURED AND UNSECURED TRANSACTIONS

This subsection is intended to be a general reference for an examiner's review of a credit file to determine whether the bank's collateral position is properly documented. Examiners should be aware that secured transactions encompass an extensive body of law that is rather technical in nature. The following discussion contains general information for examiners on the basic laws that govern a bank's security interest in property and on the documentation that needs to be in a loan file to properly document a perfected security interest in a borrower's assets.

Secured Transactions

Most secured transactions in personal property and fixtures are governed by article 9 of the Uniform Commercial Code (UCC). The UCC has been adopted by all 50 states, the District of Columbia, and the Virgin Islands. Timing differences as well as filing locations differ from state to state. Failure to file a financing statement in a timely manner or in the proper location will compromise a lender's security interest in the collateral.

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. Mortgage transactions are not covered, marine mortgages are filed with the Coast Guard, and aircraft liens are filed with the Federal Aviation Administration. A "security interest" is defined in the UCC as "an interest in personal property or fixtures which secures payment or performance of an obligation." A secured transaction requires that there be an *agreement* between the parties indicating the parties' intention to create a security interest for the benefit of the creditor or secured party. This agreement is commonly referred to as a security agreement.

Article 9 of the UCC refers to two different concepts related to security interests: attachment and perfection. Attachment is the point in time at which the security interest is created and becomes enforceable against the debtor. Perfection refers to the steps that must be taken in order for the security interest to be enforceable against third parties who have claims against collateral.

Attachment of Security Interest

The three requirements for the creation of a security interest are stated in UCC section 9-203(1). Once the following requirements are met, the security interest attaches:

- The collateral is in the possession of the secured party pursuant to agreement, or the debtor has signed a security agreement that contains a description of the collateral and, when the security interest covers crops now growing or to be grown or timber to be cut, a description of the land concerned.
- Value has been given to the debtor.
- The debtor has rights in the collateral.

Thus, unless the collateral is in the possession of the secured party, there must be a written security agreement that describes the collateral. The description does not have to be very specific or detailed—“any description of personal property…is sufficient whether or not it is specific if it reasonably identifies what is described” (see section 9-110). The agreement must also be signed by the debtor. The creditor may sign it, but its failure to do so does not affect the agreement’s enforceability against the debtor.

“Giving value” is any consideration that supports a contract. Value can be given by a direct loan, a commitment to grant a loan in the future, the release of an existing security interest, or the sale of goods on contract.

While the debtor must have “rights” in the collateral, he or she does not necessarily have to have title to the property. For example, the debtor may be the beneficiary of a trust (the trustee has title of trust assets) or may lease the collateral. The debtor, in such cases, has rights in the collateral, but does not hold the title to the collateral. The secured party, however, only obtains the debtor’s limited interest in the collateral on default if the debtor does not have full title to the collateral.

Perfection of Security Interest in Property

Perfection represents the legal process by which a bank secures an interest in property. Perfection provides the bank assurance that it has an interest in the collateral. The category of collateral will dictate the method of perfection to be used. The most common methods of perfection are (1) automatic perfection when the security interest attaches (such as in the case of purchase-money security interests applicable to consumer goods other than vehicles); (2) perfection by possession; (3) the filing of a financing statement in one or more public filing offices (The financing statement is good for five years, and the lender must file for a continuation within the six-month period before expiration of the original statement.) and (4) compliance with a state certificate of title law or central filing under a state statute other than the UCC, such as registration of vehicles.

The most common method of perfecting a security interest is public filing. Public filing serves as a constructive notice to the rest of the world that the bank claims a security interest in certain property of the debtor described in both the security agreement and the financing statement. Public filing is accomplished by filing a financing statement (UCC-1) in a public office, usually the county recorder or secretary of state. The system of filing required by the UCC provides for a notice filing whereby potential creditors can determine the existence of any outstanding liens against the debtor’s property.

The form of the financing statement and where to file it varies from state to state. While the filing of a nonstandard form will generally be accepted, the failure to file in the proper public office can jeopardize the priority of the lender’s security interest. The UCC provides three alternative filing systems:

- *Alternative System One.* Liens on minerals, timber to be cut, and fixtures are filed in the county land records. All other liens are filed in the office of the secretary of state.
- *Alternative System Two.* The majority of states have adopted this version. It is the same as system one, except liens on consumer goods, farm equipment, and farm products are filed in the county where the debtor resides or in the county where the collateral is located if it is owned by a nonresident.
- *Alternative System Three.* In a minority of states, filings made with the secretary of state must

also be filed in the county of the borrower's business (or residence if there is no place of business in that state). Otherwise, the requirement in these states is the same as system two.

As each state may select any of the above three alternatives or a modified version of them, it is important that the examiner ascertain the filing requirements of the state(s) where the bank's customer operates. Most importantly, it is the location of the borrower, not the bank, that determines where the financing statement must be filed.

Evaluation of Security Interest in Property

Key items to look for in evaluating a security interest in property include the following:

- *Security agreement.* There should be a proper security agreement, signed and dated by the borrower, that identifies the appropriate collateral to be secured. It should include a description of the collateral and its location in sufficient detail so the lender can identify it, and should assign to the lender the right to sell or dispose of the collateral if the borrower is unable to pay the obligation.
- *Collateral possession.* If the institution has taken possession of the collateral to perfect its security interest, management of the institution should have an adequate record-keeping system and proper dual control over the property.
- *Financing statement.* If the institution has filed a financing statement with the state or local authority to perfect its security interest in the collateral, in general, it should contain the following information:
  — names of the secured party and debtor
  — the debtor's signature
  — the debtor's mailing address
  — the address of the secured party from which information about the security interest may be obtained
  — the types of the collateral and description of the collateral (Substantial compliance with the requirements of UCC section 9-402 is sufficient if errors are only minor and not seriously misleading. Some states require the debtor's tax ID number on the financing statement.)
- *Amendments.* Not all amendments require the borrower's signature, and banks may file an amendment for the following reasons:
  — borrower's change of address
  — creditor's change of address
  — borrower's name change
  — creditor's name change
  — correction of an inaccurate collateral description
  — addition of a trade name for the borrower that was subsequently adopted
- *Where to file a financing statement.* In general, financing statements filed in good faith or financing statements not filed in all of the required places are effective with respect to any collateral covered by the financing statement against any person with knowledge of the statement's contents. If a local filing is required, the office of the recorder in the county of the debtor's residence is the place to file. If state filing is required, the office of the secretary of state is the place to file.
- *Duration of effectiveness of a financing statement.* Generally, effectiveness lapses five years after filing date. If a continuation statement is filed within six months before the lapse, effectiveness is extended five years after the last date on which the filing was effective. Succeeding continuation statements may be filed to further extend the period of effectiveness.

Perfection of Security Interest in Real Estate

As previously mentioned, real estate is expressly excluded from coverage under the UCC. A separate body of state law covers such interests. However, for a real estate mortgage to be enforceable, the mortgage must be recorded in the county where the real estate covered by the mortgage is located.

Real estate mortgage or deed of trust. When obtaining a valid lien on real estate, only one document is used, the mortgage or deed of trust. The difference between a mortgage and a deed of trust varies from state to state; however, the primary difference relates to the process of foreclosure. A mortgage generally requires a judicial foreclosure, whereas, in some states, a foreclosure on a deed of trust may not. Nearly all matters affecting the title to the real estate, including the ownership thereof, are recorded in the recorder's office.

When determining the enforceability of a real estate mortgage or deed of trust, the examiner should be aware of the following requirements:

- The mortgage must be in writing.
- To be recordable, the mortgage must be acknowledged. There are different forms of acknowledgments for various situations depending on whether individuals, corporations, partnerships, or other entities are executing the mortgage. Make sure that the form of the acknowledgment used is in accordance with the type of individual or entity executing the mortgage.
- If a corporation is the mortgagor, its articles of incorporation or bylaws often will specifically state which officers have authority to sign an instrument affecting real estate. In these instances, the designated officer should be required to sign. If the corporation has a seal, that also must be affixed. If the corporation does not have a seal, this fact must be shown in the acknowledgment.
- As soon as possible after the mortgage is executed, it should be recorded in the office of the recorder for each county in which the property described in the mortgage is located. In most cases, the borrower signs an affidavit that indicates, in part, that he or she will not attempt to encumber the property while the lender is waiting for the mortgage to be recorded. In smaller community banks, common practice may be not to advance any of the money under the loan until the mortgage has been recorded and the later search completed. In larger banks or cities, however, this practice is often not practical.
- If the mortgagor is married, the spouse must join in the execution of the mortgage to subject his or her interest to the lien of the mortgage. If the mortgagor is single, the mortgage should indicate that no spouse exists who might have a dower interest or homestead interest in the property.
- If the mortgagor is a partnership, it must be determined whether the title is in the name of the partnership or in the names of the individual partners. If the title is in the names of the individual partners, their spouses should join in executing the mortgage. If the title is in the name of the partnership, those partners who are required to sign under the partnership agreement should sign.

Unsecured Transactions

Unsecured transactions are granted based on the borrower's financial capacity, credit history, earnings potential, and liquidity. Assignment of the borrower's collateral is not required, and repayment is based on the terms and conditions of the loan agreement. While unsecured loans often represent the bank's strongest borrowers, the unsecured loan portfolio can represent its most significant risk. One of the primary concerns related to unsecured credit is that if the borrower's financial condition deteriorates, the lender's options to work out of the lending relationship deteriorate as well. In general, if a credit is unsecured, the file should contain reliable and current financial information that is sufficient to indicate that the borrower has the capacity and can be reasonably expected to repay the debt.

Problem Loans

The following are key signals of an emerging problem loan:

- *Outdated or inaccurate financial information on the borrower.* The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management should also be requesting a personal tax return (and all related schedules) on the borrower. While borrowers will usually present their personal financial statements in the most favorable light, their income tax return provides a more conservative picture.
- *The crisis borrower.* The borrower needed the money yesterday, so the bank advanced unsecured credit.
- *No specific terms for repayment.* The unsecured loan has no structure for repayment, and it is commonly renewed or extended at maturity.
- *Undefined source of repayment.* These types of loans are often repaid through excess cash flow of the borrower, sale of an asset(s), or loan proceeds from another financial institution. These repayment sources are often not identified and are unpredictable.

Commercial Loan-Sampling Techniques

Sampling techniques are a valid and efficient method for reviewing the commercial loan portfolios at banks during on-site examinations. Sampling enables the examiner to draw conclusions regarding the condition of the entire loan portfolio by reviewing only a selected portion. These techniques make more efficient use of examination resources and allow examiners to devote more of their time and efforts to other areas of the examination.

Generally, a judgmental sampling technique is used for reviewing commercial loans. This technique enables examiners to evaluate the portfolio by reviewing a desired percentage of all the loans over a preselected cutoff amount. In addition to the judgmental sampling approach, statistical sampling techniques can also be valid methods for evaluating loan portfolios. Two statistical sampling techniques that may be selectively implemented during on-site examinations are attributes sampling and proportional sampling. Attributes sampling is especially well-suited for large banks that have formal loan review programs; proportional sampling may be better suited for smaller or regional banks without internal loan-review programs.

In statistical sampling, the examiner uses the concepts of probability to apply sampling techniques to the design, selection, and evaluation of loan samples. Statistical sampling eliminates (or at least minimizes) potential selection biases because each item in the sample-loan population must have an equal or otherwise determinable probability of being included in the examined portion. This probability provides the examiner with a quantitative, controllable measure of risk.

Generally, statistical sampling techniques may be implemented only in those banks (1) that were found to be in financially sound condition, (2) that were without any undue loan portfolio problems at the latest examination, and (3) where it was determined that the systems and controls were appropriate for implementing such techniques. Moreover, if during an examination, the examiner determines that the statistical sampling results are unsatisfactory, the traditional judgmental sampling technique should be implemented.

The two recommended statistical sampling techniques are described below:

- *Attributes Sampling.* The objective of attributes sampling is to determine from a sample, within specified reliability limits, the validity of the bank's internal loan-review program. The reliability limits are determined by the examiner, who formulates a hypothesis about the bank's loan-review program when evaluating its policies, practices, and procedures for loan extensions. The population to be sampled consists of all loans between certain dollar parameters, except for loans reviewed under the shared national credit program and loans to identified problem industries (the latter are reviewed separately during the examination). The lower dollar parameter is an amount that the examiner deems sufficient to achieve the desired coverage of the loan portfolio and is selected in much the same manner as a cutoff line is chosen in judgmental sampling. The upper dollar parameter is an amount over which all loans must be reviewed because of the significant effect each could have on the bank's capital. Loans are selected from the sample population by using a random digit table.

  When the selected loans are reviewed, the examiner compares his or her grading with those of the bank's loan-review program. An "error" generally exists if the examiner's grading of a particular loan is significantly more severe than the bank's grading. If the error rate in the sample is beyond the preestablished reliability limits the examiner is able to accept, all loans over the cutoff amount should be reviewed. If the examiner is satisfied with the sample results, the bank's internal grading will be accepted for all criticized loans that have not been independently reviewed within the sample population. Even when the bank's internal grading is deemed acceptable by the examiner, any loans reviewed and found to be in error will be appropriately classified in the report.
- *Proportional Sampling.* The procedures for proportional sampling are similar to those followed for attributes sampling. The objective of this sampling technique is to determine whether bank management can identify all the criticizable loans in the portfolio. The examiner formulates a hypothesis about the quality of the examined bank's loan administration, based on an analysis of loan policies, practices, and procedures for loan extensions. In proportional sampling, every loan in the sample population is given an equal chance of

selection in proportion to its size, so the larger the loan, the more likely it will be selected for review. Examiners grade the loans in the sample and compare these gradings with the bank's problem-loan list.

As in attributes sampling, the examiner specifies the desired precision of the sample, that is, that the true error rate in the bank's problem-loan list should be within a certain range of values. A statistical error occurs whenever the examiner criticizes a loan that is not criticized by the bank. If the error rate is higher than expected, the examiner will review all loans over a cutoff line, which is determined using the same criteria as line selection in judgmental sampling. If the sample results indicate an error rate within expectations, then the examiner will accept the bank's problem-loan list as a reliable list of the nonpass loans in the population from which the sample was taken. The examiner will then review and grade each loan on the problem-loan list over the cutoff amount.

For detailed procedures on how to implement both attributes and proportional sampling, examiners should contact either Reserve Bank supervision staff or Federal Reserve Board supervision staff.

REVIEWING CREDIT QUALITY

Importance of Cash Flow

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in a business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

Analysis and Limitations of Cash Flow

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. In reality, examiners face time constraints that often prevent them from performing the complex mathematical calculations involved in sophisticated cash-flow analysis. Therefore, the cash-flow methods presented below were designed to be reasonable and practical for examiner use. *However, examiners should be careful of conclusions reached using the traditional cash-flow analysis, without consideration to balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings.* If the credit file contains a CPA-prepared statement of cash flow or a statement prepared using the accrual conversion method, the examiner should concentrate efforts on reviewing and analyzing these statements rather than on preparing a traditional cash-flow statement.

One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, deficit cash flow is caused by a business's experiencing significant growth, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan is criticized.[1]

1. Examiners should make sure that they are using financial data from consistent periods, that is, year-to-date financial information. Mixing annual financial data with interim financial information can cause misinterpretation of cash flow for a given business cycle or annual period.

Components of the Accrual Conversion Method of Cash Flow

Category	*Basis for Amount*
Sales:	Dollar amount of sales in period
+/−change in A/R, INV., A/P:	Represents the absolute difference of the current period from the corresponding period of the previous year in accounts receivable, inventory, and accounts payable.
Formula:	(a) An increase in any current asset is a use of cash and is subtracted from the calculation. Conversely, a decrease in any current asset is a source of cash and is added to the calculation. (b) An increase in any current liability is a source of cash and is added to the calculation. Conversely, a decrease in any current liability is a use of cash and is subtracted from the calculation.
SGA:	Subtract selling, general, and administrative expenses.
Interest Expense:	Add interest expense to the calculation if SGA "expense" includes interest expense.
Excess (Deficit) Cash Flow:	Represents cash available before debt service.

Calculation of Supplemental/Traditional Cash Flow

Net Income:	Amount of net income reported on most recent annual income statement before taxes.
Interest Expense:	Add the total amount of interest expense for the period.
Depreciation/ Amortization:	Add all noncash depreciation and principal amortization on outstanding debt.
Cash Flow before Debt Service:	Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest payments required on debt.
Debt Service:	Subtract scheduled principal and interest payments.
Capital Expenditures:	Subtract all capital expenditures for the period.
EQUALS— Excess (Deficit) Cash Flow:	Total amount of excess or deficit cash flow for the period after debt service.
Coverage Ratio:	Cash flow before debt service divided by debt service (principal and interest).

Importance of Financial Analysis

While cash-flow analysis is critical in reviewing whether a borrower has the ability to repay individual debt, a review of the borrower's other financial statements can offer information about other sources of repayment, as well as the borrower's overall financial condition and future prospects. The availability of historical balance-sheet and income information, which allow declining trends to be identified, is critical. Also, it may be appropriate to compare the borrower's financial ratios with the average for the industry overall. Much of the financial information that examiners will review will not be audited; therefore, considerable understanding of general accounting principles is necessary to competently review an unaudited financial statement. The bank should obtain at least annual financial statements from a borrower.

When reviewing a credit file of a borrowing customer of a bank, the following financial information should be available for review: income statement, balance sheet, reconciliation of equity, cash-flow statements, and applicable notes to financial statements. The components for a financial review can be segregated into three areas: operations management, asset management, and liability management. Operations management is derived from the income statement and can be used to assess company sales, cost control, and profitability. Asset management involves the analysis of the quality and liquidity of assets, as well as the asset mix. Liability management covers the analysis of the company's record of matching liabilities to the asset conversion cycle, such as long-term assets being funded by long-term liabilities.

In studying the above forms of management, various ratios will help the examiner form an informed and educated conclusion about the quality of the credit being reviewed. The ratios can be divided into four main categories:

- *Profitability ratios.* These ratios measure management's efficiency in achieving a given level of sales revenue and profits, as well as management's ability to control expenses and generate return on investment. Examples of these ratios include gross margin, operating profit margin, net profit margin, profit to sales ratio, profit to total assets ratio, and direct cost and expense ratios.
- *Efficiency ratios.* These ratios, which measure management's ability to manage and control assets, include sales to assets, inventory days on hand, accounts receivable days on hand, accounts payable days on hand, sales to net fixed assets, return on assets, and return on equity.
- *Leverage ratios.* These ratios compare the funds supplied by business owners with the financing supplied by creditors, and measure debt capacity and ability to meet obligations. These ratios may include debt to assets, debt to net worth, debt to tangible net worth, and interest coverage.
- *Liquidity ratios.* Include ratios such as the current ratio and quick ratio, which measure the borrower's ability to meet current obligations.

Common "Red Flags"

The symptoms listed below are included to provide an understanding of the common problems or weaknesses examiners encounter in their review of financial information. While one symptom may not justify criticizing a loan, when symptoms are considered in the aggregate, they may help the examiner detect near-term trouble. This list is only a sampling of "red flags" that should prompt further review; examiners should also be able to identify issues that may require further investigation from their cursory review of a borrower's financial statement.

- *A slowdown in the receivables collection period.* This symptom often reveals that the borrower has become more liberal in establishing credit policies, has softened collection practices, or is encountering an increase in uncollected accounts.
- *Noticeably rising inventory levels in both dollar amount and percentage of total assets.* Increases in inventory levels are usually supported by trade suppliers, and financing these increases can be extremely risky, particularly if turnover ratios are declining. The increase in inventory levels or lower turnover ratios may also be related to the borrower's natural reluctance to liquidate excessive or obsolete goods at a reduced price. Many businesses are willing to sacrifice liquidity to maintain profit margins.
- *Slowdown in inventory turnover.* This symptom may indicate overbuying or some other imbalance in the company's purchasing policies, and it may indicate that inventory is slow-moving. If the inventory is undervalued, the actual turnover is even slower than the calculated results.
- *Existence of heavy liens on assets.* Evidence of second and third mortgage holders is a sign of greater-than-average risk. The cost of junior money is high. Most borrowers are reluctant to use this source of funds unless conventional sources are unavailable.
- *Concentrations of noncurrent assets other than fixed assets.* A company may put funds into affiliates or subsidiaries for which the bank may not have a ready source of information on operations.
- *High levels of intangible assets.* Intangible assets, which shrink or vanish much more quickly than hard assets, usually have very uncertain values in the marketplace. In some cases, however, intangible assets such as patents or trademarks have significant value and should be given considerable credit.
- *Substantial increases in long-term debt.* This symptom causes increasing dependence on cash flow and long-term profits to support debt repayment.

- *A major gap between gross and net sales.* This gap represents a rising level of returns and allowances, which could indicate lower quality or inferior product lines. Customer dissatisfaction can seriously affect future profitability.
- *Rising cost percentages.* These percentages can indicate the business's inability or unwillingness to pass higher costs to the customer or its inability to control overhead expenses.
- *A rising level of total assets in relation to sales.* If a company does more business, it will take more current assets in the form of inventory, receivables, and fixed assets. Examiners should be concerned when assets are increasing faster than sales growth.
- *Significant changes in the balance-sheet structure.* These changes may not be the customary changes mentioned previously, but they are represented by marked changes spread across many balance-sheet items and may not be consistent with changes in the marketplace, profits or sales, product lines, or the general nature of the business.

REQUIRED MINIMUM DOCUMENTATION STANDARDS FOR LOAN LINE SHEETS

Certain minimum documentation must appear on all line examination sheets to leave an acceptable audit trail and to support the classification of designated loans. Currently, much of this information is often placed on the line ticket automatically by using computer-based loan-review systems. However, the disposition of the loan and the reasons for that disposition are the most crucial entries on the line ticket. Examiners must document their entries and decide how much of the documentation is required to support the loan-review decision. That decision and a summary of the reasons a loan is passed, listed for special mention, or adversely classified should be provided (preferably in bullet form) on the loan line ticket. Beyond that, the documentation will vary depending on the complexity and profile of the credit. The examiner may provide more detailed information on the collateral, cash flow, and repayment history. This additional information is not mandatory if the rationale for the disposition of the credit is otherwise clear.

The extension of credit line sheets and workpapers should document loan discussion comments, identify the examiner who reviewed the credit, and identify the officer(s) with whom the credit was discussed. Line sheets should also include the examiner's conclusion on the specific credit and the reasons for that conclusion.

As part of a review of examination and supervisory policies and procedures and to promote consistency, the items described below have been implemented as required minimum documentation standards for loan line sheets. These standards recognize a transactional approach in examinations and reflect the efficiencies inherent in a risk-focused approach to examinations. The amount of information that should be documented or included as part of a line sheet may vary depending on the type, complexity, and materiality of the credit. However, all line sheets should include the following information to satisfy the required minimum documentation standards, as set forth by SR-99-25 ("Minimum Documentation Standards for Loan Line Sheets," September 29, 1999). The first seven items are frequently provided through computer-based loan-review systems.

- *Name and location of borrower.* Document the name of the individual or company responsible for repayment of the debt.
- *Notation if the borrower is an insider or a related interest of an insider.* If the borrower is an insider or a related interest of the insider as defined by Regulation O, reflect this association on the line sheet.
- *Business or occupation.* Briefly describe the legal entity and the type of business in which the company is engaged, according to the following definitions:
  - — *Corporation.* A business organization that is owned by shareholders who have no inherent right to manage the business. The organization is generally managed by a board of directors that is elected by the shareholders. The file should contain the borrowing resolution indicating which officers from the corporation are authorized to sign on its behalf. Indicate if the corporation is closely held.
  - — *Partnership.* A business organization, specifically, an association of two or more persons to carry on as co-owners of a business for profit. Indicate if it is a general partnership (GP) or limited partnership (LP). If GP, each partner is fully liable for the firm's debts and actions. If LP, at least one general partner is fully

liable, but there will also be a number of partners whose liability is limited to that enumerated by the partnership agreement. Indicate each partner's proportionate interest (such as 25 or 50 percent).
   — *Proprietorship.* A form of business organization that is owned and operated by an individual. If the borrower is an individual, include his or her primary occupation.
- *Loan terms.* Include the following loan information[2]:
   — date of origination (note subsequent renewals and/or extensions)
   — repayment terms (for example, maturity, periodic payments, revolving)
   — maturity (restructured loans should be noted as such)
   — interest rate (fixed or variable) (If variable, state the basis (index) upon which the interest rate is determined.)
   — originated amount of the loan
- *Purpose of loan.* Note the purpose of each credit facility.
- *Repayment source.* Indicate the primary and secondary sources of repayment for each credit facility.
- *Collateral summary and value.* Describe collateral and assess the value of the collateral in which the bank maintains a perfected security interest. Values should be supported by some type of document, such as a recent financial statement, formal appraisal, management estimate, or any publication that maintains a current market value of collateral. At a minimum, the collateral assessment should include the following information:
   — collateral value
   — basis for valuation
   — date of valuation
   — control of collateral
   — current lien status
- *Loan officer assigned to the credit and the internal rating of the credit.* Note the name of the loan officer responsible for the loan. Also document the bank's internal risk-rating. The date of the most recent update of the rating should also be noted. Particular attention should be given to the consistency between the loan classification at the current examination and the assessment provided by the bank's internal loan-review department. Significant disparities should be noted in the asset-quality assessment.
- *Total commitment and total outstanding balances.* Indicate the total amount of the bank's legal commitment or line of credit available to the borrower. Note the total outstanding debt to the borrower as of the date of examination.
- *Examination date.* Indicate the as-of date of the examination.
- *Past-due or nonaccrual status.* Indicate the past-due status (current, nonaccrual, and days past due).
- *Amounts previously classified.* Note the loan amount and how the loan was previously classified at the most recent examination (Federal Reserve Bank or state).
- *Loan disposition (pass, special mention, or adverse classification).* Note the credit amount and how the credit is being classified, such as pass, special mention, substandard, doubtful, or loss.
- *Rationale for examiner's conclusions (preferably in bullet form).* Indicate the reasons for passing the credit or extending it for criticism, which should be consistent with the classification descriptions noted in the "Classification of Credits" section.
- *Name or initials of the examiner reviewing the credit.* Indicate the name or initials of the examiner who reviewed and assigned the classification to the credit.
- *Any significant comments by, or commitments from, management.* Clearly and specifically indicate relevant comments (including management's disagreement with the disposition of the loan, if applicable) that may be considered when determining whether or not to criticize the credit. Comments can include officer's comments noted in the credit file, information derived from discussions with management, questions the examiner may have about the borrower, or any other item deemed appropriate. If management plans to get out of the credit relationship, a workout strategy should be included in this section. Comments should be included as to why management disagrees with any loan classification or how any loan was classified.
- *Any noted documentation exceptions or loan-administration policy or procedural weaknesses, and any contravention of law, regulation, or policy.* Indicate any documentation exception or violation of law, regulation, or

2. If the loan is a shared national credit (SNC), this should be noted on the line sheet. A copy of the SNC write-up should be attached to the line sheet, and it is not necessary to provide any additional data.

policy that would be appropriate to include as part of the report of examination. The examiner may include any technical exception noted from the credit file that would inhibit the ability of the loan officer or the examiner to make an informed and/or competent judgment about the quality of the credit relationship.

When needed, loan line sheets should briefly note that information is not available or that certain information is not reliable due to deficient loan-administration systems and processes, particularly with respect to loan and collateral documentation and collateral values. If such deficiencies are material, a listing of the exceptions should be noted in the examination report. In addition, the effect of these loan-administration weaknesses should be discussed and factored into the risk-management rating.

Optional Information for Loan Line Sheets

In addition to the above information, additional items should be listed when needed to describe the terms of the credit and/or the disposition accorded to it by the examiners, for example, guarantors, amount of any specific reserve, or amounts previously charged off, as described below:

- *Related debt/tie-ins.* The name, total debt outstanding, and type of borrowings (such as real estate, commercial, installment debt) of the related party might be indicated.
- *Guarantor(s).* If a guarantor exists, the name, amount of the guaranty, and date the guaranty was signed can be noted. A summary and an assessment of data supporting a guaranty may also be included, along with current financial information from the guarantor(s) which the bank should obtain at least annually. Tax returns and supporting schedules, income statements, and other pertinent information on the guarantor(s) may be appropriate under certain circumstances. If a troubled credit, indicate whether the guarantor has exhibited any willingness to financially support the credit.
- *Summary of financial data.* The following information may be appropriate, based on the type and complexity of the loan:
  - — key balance-sheet information (current ratio, D/E ratio)
  - — key income items (EBITDA—earnings before income taxes, depreciation, and amortization; net income; profit margin)
  - — cash-flow coverage (debt-service coverage, interest coverage)
  - — source of financial data (company-prepared balance sheet, audited financial statement)
- *Dates and amounts of previous charge-offs.*
- *Specific reserves.* The examiner may indicate whether an amount (allocated reserve) was specifically set aside to absorb any loss from the credit. When evaluating the overall adequacy of the loan-loss reserve, subtract the aggregate of allocated reserves from the total reserve balance, and subtract the aggregate amount of loans for which allocated reserves exist from the total loan balance.
- *The name of the loan officer who may have offered the most pertinent discussion items that affected the classification decision.*

BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (the code) chapters that affect commercial and industrial loans. Bankruptcy law is a significant body of law; it would be difficult in this manual to discuss all the issues necessary for comprehensive understanding of the code. This subsection will focus on basic issues that an examiner needs to be familiar with relative to three principal sections of the code: chapters 7, 11, and 13.

Creditors of a Bankrupt Business

A creditor in bankruptcy is anyone with a claim against a bankrupt business, even if a formal claim is not filed in the bankruptcy case. In bankruptcy court, a claim is defined very broadly. A claim may include a right to payment from a bankrupt business, a promise to perform work, or a right to a disputed payment from the debtor that is contingent on some other event. The two basic types of creditors are secured and unsecured. Secured creditors are those with perfected security interest in specific property, such as equipment, accounts receivable, or any other asset pledged as collateral on a loan. Unsecured creditors are generally trade creditors and others who have not taken a specific interest in property supplied to the bankrupt debtor.

Voluntary Versus Involuntary Bankruptcy

When a debtor files a bankruptcy petition, it is described as a voluntary bankruptcy filing. The individual or organization does not have to be insolvent to file a voluntary case. Creditors may also file a bankruptcy petition, in which case the proceeding is known as an involuntary bankruptcy. This form of petition can occur in chapters 7 and 11 bankruptcy cases, and the debtor generally must be insolvent. To be deemed insolvent, the debtor must be unable to pay debts as they mature. However, the code does limit who an involuntary action can be sought against.

Chapter 7—Liquidation Bankruptcy

A chapter 7 action may be filed by virtually any person or business organization that is eligible to file bankruptcy. Chapter 7 bankruptcy can be filed by a sole proprietorship, partnership, corporation, joint stock company, or any other business organization. Restrictions apply to only a few highly regulated businesses, such as railroads, insurance companies, banks, municipalities, and other financial institutions. This chapter is often referred to as "straight liquidation," or the orderly liquidation of all assets of the entity. Generally, a debtor in a chapter 7 bankruptcy case is released from obligations to pay all dischargeable prebankruptcy debts in exchange for surrendering all nonexempt assets to a bankruptcy trustee. The trustee liquidates all assets and distributes the net proceeds on a pro rata basis against the allowed claims of unsecured creditors. Secured creditor claims are generally satisfied by possession or sale of the debtor's assets. Depending on the circumstances, a secured creditor may receive the collateral, the proceeds from the sale of the collateral, or a reaffirmation of the debt from the debtor. The reaffirmed debts are generally secured by property that the debtor can exempt from the bankruptcy estate, such as a home or vehicle. The amount of the reaffirmation is limited to the value of the asset at the time of the bankruptcy filing. Some characteristics of a chapter 7 bankruptcy are described below:

- A trustee is appointed in all chapter 7 bankruptcies and acts as an administrator of the bankruptcy estate. The bankruptcy estate that is established when the petition is filed becomes the legal owner of the property. The trustee acts to protect the interest of all parties affected by the bankruptcy.
- The trustee has control of all nonexempt assets of the bankrupt debtor.
- The trustee is required to liquidate the estate quickly without jeopardizing the interests of the affected parties.
- The proceeds from the sale pay trustee's fees and other creditors. Trustee fees are determined according to the amount disbursed to the creditors and are a priority claim.
- A chapter 7 bankruptcy is typically completed in 90 days, depending on the time needed to liquidate collateral. Some chapter 7 bankruptcies take years to complete.
- The court may allow the trustee to continue to operate a business, if this is consistent with the orderly liquidation of the estate.

Chapter 11—Reorganization

Most major or large businesses filing bankruptcy file a chapter 11 reorganization. As in chapter 7, virtually any business can file a chapter 11 reorganization. There are specialized chapter 11 reorganization procedures for certain businesses such as railroads, and chapter 11 is not available to stockbrokers, commodity brokers, or a municipality. The basic concept behind chapter 11 is that a business gets temporary relief or a reprieve from paying all debts owed to creditors. This temporary relief gives the business time to reorganize, reschedule its debts (at least partially), and successfully emerge from bankruptcy as a viable business. The basic assumption underlying a chapter 11 bankruptcy is that the value of the enterprise as a going concern will usually exceed the liquidation value of its assets.

Reorganization Plan

Generally, the debtor has an exclusive 120-day period to prepare and file a reorganization plan. If the debtor's plan has not been confirmed within 180 days of the bankruptcy filing, a creditor may file a plan. A plan can provide for any treatment of creditor claims and equity interest, as long as it meets the requirements set out in the code. For example, a plan must designate substantially similar creditor claims and equity interest into classes and provide for equal treatment of such class members. A plan must also identify those classes with impaired claims and their proposed treatment. Finally, a method of implementation must be provided. Although plans do not have to be filed by a deadline, the bankruptcy judge will generally place a deadline on the debtor or creditor authorized to prepare the plan.

Some characteristics of a chapter 11 bankruptcy are described below.

- The bankrupt debtor usually controls the business during the bankruptcy proceedings. This arrangement is referred to as "debtor in possession."
- The business continues to operate while in bankruptcy.
- The debtor is charged with the duty of developing a reorganization plan within the first 120 days of the filing. After this period expires, the court may grant this authority to a creditors' committee.
- Once the plan is approved by the bankruptcy court, the debtor's payment of debts is generally limited to the schedule and amounts that are detailed in the reorganization plan.
- A chapter 11 proceeding can be complex and lengthy, depending on the number of creditors, amount of the debts, amount of the assets, and other factors that complicate the proceedings.

Chapter 13—Wage-Earner Bankruptcy

A chapter 13 bankruptcy is available to any individual whose income is sufficiently stable and regular to enable him or her to make payments under the plan. As long as the individual has regular wages or takes a regular draw from his or her business, the individual may qualify under chapter 13 of the code. Under chapter 13, an individual or married couple can pay their debts over time without selling their property. As a protection to creditors, the money paid to a creditor must equal or exceed the amount that the creditor would get in a liquidation or chapter 7 bankruptcy. Chapter 13 may be used for a business bankruptcy, but only if the business is a proprietorship. In most cases, the business needs to be fairly small to qualify.

Some characteristics of a chapter 13 bankruptcy are described below:

- In most cases, only an individual can file a chapter 13 bankruptcy.
- Secured debt may not exceed $350,000.
- Unsecured debt may not exceed $100,000.
- The debtor must propose a good-faith plan to repay as many debts as possible from available income.
- A debtor makes regular payments to a trustee, who disburses the funds to creditors under the terms of the plan.
- The trustee does not control the debtor's assets.
- A chapter 13 bankruptcy may include the debts of a sole proprietorship. The business may continue to operate during the bankruptcy.
- After all payments are made under the plan, general discharge is granted.

SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT

The intent of this subsection is to provide examiners with general guidance on how to identify potential violations of sections 23A and 23B of the Federal Reserve Act as they pertain to the commercial-lending function. More specific guidance on sections 23A and 23B of the Federal Reserve Act can be obtained from the Board's Regulation W (12 CFR part 223) as well as the sections of this manual on Regulation W.

Section 23A

Section 23A of the Federal Reserve Act was designed to prevent misuse of a bank's resources stemming from non-arm's-length transactions with affiliates. Examiners will first need to determine if the bank and counterparty involved in a transaction are affiliates. Once this relationship is determined, the examiner will need to decide if the transaction is included in the statute as a "covered transaction." Generally, covered transactions within the lending function of the institution would include any loan or extension of credit to an affiliate, as defined by Regulation W, which defines extensions of credit to mean any similar transaction as a result of which an affiliate becomes obligated to pay money or its equivalent to the bank. Any transaction by a bank with any person is deemed to be a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to an affiliate. A key element of section 23A is that covered transactions between a bank and its affiliate must be on terms and conditions consistent with safe and sound banking practices.

Once the examiner has determined that the counterparty is an affiliate and that the transaction is a covered transaction, there are quantitative limitations that apply. Section 23A limits the amount of covered transactions between a bank and its subsidiary and a single affiliate to no more than 10 percent of the bank's capital and surplus (as defined in 12 CFR 223(d)). In addition, an institution and its subsidiaries may only engage in a covered transaction with an affiliate if, in the case of all affiliates, the aggregate amount of the covered transactions of the institution and its subsidiaries will not exceed 20 percent of the capital stock and surplus of the institution.

When the transaction involves an extension of credit to an affiliate, certain collateral requirements must also be met. Generally, extensions of credit require certain collateral margins that are tied to the type of collateral. For example, extensions of credit that are secured by U.S. Treasury securities or certain agency securities require a collateral margin of 100 percent of the transaction amount, whereas collateral consisting of stock, leases, or other real or personal property requires a margin of 130 percent. Some collateral, such as the obligations of an affiliate, are not eligible as collateral for transactions between a bank and its affiliates. Certain exemptions to the specific collateral requirements of section 23A were included to permit transactions that posed little risk to the bank and to prevent undue hardship among the affiliated organizations in carrying out customary transactions with related entities. These exemptions include various transactions that are related to sister-bank relationships, correspondent relationships, and uncollected items in the process of collection.

Section 23B

Section 23B defines affiliates in the same manner as section 23A, except that all banks are excluded from section 23B as affiliates. The principal requirements of section 23B state that any transaction between a bank and a defined affiliate under the act must be (1) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (2) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered or would apply to nonaffiliated companies. In short, the terms and conditions of an extension of credit to an affiliate under section 23B should be no more favorable than those that would be extended to any other borrowing customer of the bank. For covered transactions, all transactions that are covered under section 23A are covered under section 23B; however, section 23B expanded the list to include other transactions such as the sale of securities or other assets to an affiliate, the payment of money or furnishing of services to an affiliate, or any transaction if the affiliate has a financial interest or participates in the transaction.

The focus of section 23B is different from that of section 23A. Section 23A contains quantitative and collateral restrictions to protect the bank; section 23B focuses on whether transactions with nonbank affiliates are arm's length and not injurious to the bank. Essentially, examiners need to keep one basic principal in mind: If money or assets flow from the bank to an affiliate other than through a dividend, the transaction is probably a covered transaction and would be subject to sections 23A and 23B. In addition, if a bank assumes the liabilities of an affiliate, the transaction is subject to sections 23A and 23B.

TYING ARRANGEMENTS

Among other things, section 106 of the Bank Holding Company Act Amendments of 1970 (section 106) prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank.[3] The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services. Although section 106 prohibits banks from imposing certain types of tying arrangements on their customers, the statute also expressly permits banks to engage in other forms of tying and authorizes the Board to grant additional exceptions to the statute's prohibitions by regulation or order. For more information on section 106, see this manual's section, "Regulation Y: Prohibitions Against Tying Arrangements."

3. 12 U.S.C. 1972.

1. To determine if lending policies, practices, procedures, and internal controls for commercial and industrial loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the commercial loan section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or 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 deficiencies noted in the latest review done by internal or external auditors, and determine if corrections have been accomplished.
4. Obtain a trial balance of the customer liability records.
   a. Agree or reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
6. Obtain the following information from the bank or other examination areas, if applicable:
   a. past-due loans
   b. loans in a nonaccrual status
   c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be given to loans that have been renewed with interest being rolled into principal.)
   d. loans whose terms have been modified by a reduction of interest-rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
   e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   g. loan commitments and other contingent liabilities
   h. loans secured by stock of other depository institutions
   i. extensions of credit to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
   j. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
   k. a list of correspondent banks
   l. miscellaneous loan-debit and credit-suspense accounts
   m. Shared National Credits
   n. loans considered "problem loans" by management
   o. specific guidelines in the lending policy
   p. each officer's current lending authority
   q. any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee
   r. reports furnished to the loan and discount committee or any similar committee
   s. reports furnished to the board of directors
   t. loans classified during the previous examination
   u. the extent and nature of loans serviced
7. Review the information received, and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
      • Participations only:
        — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      • Procedures pertaining to all transfers:
        — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were trans-

ferred to avoid possible criticism during the examination.

— Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.

— Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans. (While fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium.) Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.

— Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.

— If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
(1) name of originating institution
(2) name of receiving institution
(3) type of transfer (i.e., participation, purchase or sale, swap)
(4) date of transfer
(5) total number of loans transferred
(6) total dollar amount of loans transferred
(7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
(8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
- Discuss with management any large or old items.
- Perform additional procedures as deemed appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amount of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

d. *Loans classified during the previous examination.*
- current balance and payment status, or
- date the loan was repaid and the source of payment

Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.

e. *Review of leveraged buyouts.*
- In evaluating individual loans and credit files, pay particular attention to the reasonableness of interest-rate assumptions and earnings projections relied on by the bank in extending the loan; the trend of the borrowing company's and the industry's performance over time and the history and stability of the company's earnings and cash flow, particularly over the most recent business cycle; the relationship between the company's cash-flow and debt-service requirements and the resulting margin of debt-service coverage; and the reliability and stability of collateral values and the adequacy of collateral coverage.
- In reviewing the performance of individual credits, attempt to determine if debt-service requirements are being covered by cash flow generated by the company's operations or whether the debt-service requirements are being met out of the proceeds of additional or ancillary loans from the bank designed to cover interest changes.

- Review policies and procedures pertaining to leveraged buyout financing to ensure that they incorporate prudent and reasonable limits on the total *amount* and *type* (by industry) of exposure that the bank can assume through these financing arrangements.
- Review the bank's pricing, credit policies, and approval procedures to ensure that rates are reasonable in light of the risks involved and that credit standards are not compromised in order to increase market share. Credit standards and internal review and approval standards should reflect the degree of risk and leverage inherent in these transactions.
- Total loans to finance leveraged buyouts should be treated as a potential concentration of credit. If, in the aggregate, these loans are sufficiently large in relation to capital, the loans should be listed on the concentrations page in the examination report.
- Discuss significant deficiencies or risks regarding a bank's leveraged buyout financing on page 1 of the examination report, and bring them to the attention of the board of directors.

f. *Uniform review of Shared National Credits.*
- Compare the schedule of commercial credits included in the uniform review of the Shared National Credit Program with the loans being reviewed to determine which loans are portions of Shared National Credits.
- For each loan so identified, transcribe appropriate information from the schedule to line cards. (No further examination procedures are necessary for these credits.)

8. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources.
9. Transcribe or compare information from the schedules to commercial line cards, where appropriate.
10. Prepare commercial line cards for any loan not in the sample that, based on information derived from the above schedules, requires in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
12. Add collateral data to line cards selected in the preceding steps.
13. Obtain credit files for all borrowers for whom commercial line cards were prepared, and complete line cards. To analyze the loans, perform the following procedures:

    a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.

    b. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.

    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.

    d. Ascertain compliance with provisions of loan agreements.

    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual liquidation program.

    f. Relate collateral values to outstanding debt.

    g. Compare interest rates charged with the interest-rate schedule, and determine that the terms are within established guidelines.

    h. Compare the original amount of loan with the lending officer's authority.

    i. Analyze secondary support afforded by guarantors and endorsers.

    j. Ascertain compliance with the bank's established commercial loan policy.

    k. Determine whether public officials are receiving preferential treatment and whether there is any correlation between loans to public officials and deposits they may control or influence.

14. For selected loans, check the central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness or suspected of having additional liability in other loan areas.
15. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
16. Prepare "Report of Loans Supported by Bank Stock," if appropriate. Determine if a concentration of any bank's stock has been pledged.
17. Determine compliance with laws, rulings, and regulations pertaining to commercial lending by performing the following steps.
    a. *Lending limits.*
        - Determine the bank's lending limits as prescribed by state law.
        - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Relations with Affiliates (12 U.S.C. 371c), and section 23B, Restrictions on Transactions with Affiliates (12 U.S.C. 371c-1), of the Federal Reserve Act, and Regulation W.*
        - Obtain a listing of loans to affiliates.
        - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
        - Obtain a listing of other covered transactions with affiliates (i.e., purchase of loans from affiliates or acceptance of affiliates' securities as collateral for loan to any person).
        - Ensure that covered transactions with affiliates do not exceed the limits of section 23A and Regulation W.
        - Ensure that covered transactions with affiliates meet the appropriate collateral requirements of section 23A and Regulation W.
        - Determine that low-quality loans have not been purchased from an affiliate.
        - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
        - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    c. *18 U.S.C. 215, Receipt of Commission or Gift for Procuring Loans.*
        - While examining the commercial loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
        - Investigate any such suspected situation.
    d. *Federal Election Campaign Act (2 U.S.C. 441b), Political Contributions.*
        - While examining the commercial loan area, determine the existence of any loans in connection with any political campaigns.
        - Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.
    e. *12 U.S.C. 1972, Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon—
        - obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service;
        - the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit. (See "Tie-In Considerations of the BHC Act," section 3500.0 of the *Bank Holding Company Supervision Manual*.)
    f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):

- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
  - — test the accuracy and completeness of information about commercial loans by comparing it with the trial balance or loans sampled;
  - — review credit files on insider loans to determine that required information is available;
  - — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
  - — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
  - — determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections;
  - — if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
  - — determine compliance with the various reporting requirements for insider loans;
  - — determine that the bank has made provisions to comply with the public disclosure requirements of Regulation O; and
  - — determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years after the dates of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 U.S.C. 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  - — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  - — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *12 U.S.C. 1828(v), Loans Secured by Bank Stock.*
- While examining the commercial loan area, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
- In each case, determine that the chief executive officer has promptly reported such fact to the proper regulatory authority.

h. *12 U.S.C. 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, para. 6, of the Federal Reserve Act (12 U.S.C. 324), Loans Secured by Own Stock (see also 3-1505 in the* Federal Reserve Regulatory Service).
- While examining the commercial loan area, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
- Confer with the examiner assigned to investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
- In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent loss on a debt previously contracted (DPC) transaction.

i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
- Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
- Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.

j. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 1010), Retention of Credit Files.*
   - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.
   - Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 1010.410.) (Loans secured by an interest in real property are exempt.)

18. Determine whether the consumer compliance examination uncovered any violations of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Test for subsequent compliance with any law or regulation so noted.
19. Perform the appropriate procedural steps in "Concentration of Credits" section.
20. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans
    b. violations of laws and regulations
    c. loans not supported by current and complete financial information
    d. loans on which collateral documentation is deficient
    e. concentrations of credits
    f. criticized loans
    g. inadequately collateralized loans
    h. Small Business Administration or other government-guaranteed delinquent or criticized loans
    i. transfers of low-quality loans to or from another lending institution
    j. extensions of credit to principal shareholders, employees, officers, directors, and related interests
    k. other matters regarding the condition of the department
21. Inform the Reserve Bank of all criticized participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of loan classification comments. (This step deals with loans that deteriorated subsequent to participation and does not duplicate step 7a, which deals with transfers of loans that were of low quality when transferred).
22. Inform the Reserve Bank of those loans eligible for the Shared National Credit Program that were not previously reviewed. Include the names and addresses of all participants and the amounts of their credit. (This step applies only to credits for which the bank under examination is the lead bank.)
23. Evaluate the function for—
    a. the adequacy of written policies relating to commercial loans,
    b. the manner in which bank officers are operating in conformance with established policy,
    c. adverse trends within the commercial loan department,
    d. the accuracy and completeness of the schedules obtained from the bank,
    e. internal control deficiencies or exceptions,
    f. recommended corrective action when policies, practices, or procedures are deficient,
    g. the competency of departmental management, and
    h. other matters of significance.
24. Update the workpapers with any information that will facilitate future examinations.

Real estate lending is a major function of most banks. However, the composition of banks' real estate loan portfolios will vary because of differences in the banks' asset size, investment objectives, lending experience, market competition, and location. Additionally, state member banks' lending activity is subject to supervision by state banking regulatory agencies, which may impose limitations, including restrictions on lending territory, types of lending, percentage of assets in real estate loans, loan limits, loan-to-value ratios, and loan terms.

Because of the differences in state banking laws, this section of the manual is only an overview of the Federal Reserve's supervisory and regulatory requirements for a safe and sound real estate lending program. This section also briefly discusses automated valuation models (see SR-11-7) and other collateral-evaluation tools or methods. For specific information on lending limitations and restrictions, refer to the applicable state banking laws. In addition, information related to real estate construction lending is discussed in section 2100.1 of this manual.

REAL ESTATE LENDING POLICY MANDATED BY FDICIA

A bank's real estate lending policy is a broad statement of its standards, guidelines, and limitations that senior bank management and lending officers are expected to adhere to when making a real estate loan. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the bank's management of the lending function.

The policies governing a bank's real estate lending activities must include prudent underwriting standards that are clearly communicated to the institution's management and lending staff. The bank should also have credit-risk control procedures that include, for example, an effective credit-review and -classification process and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. As part of the analysis of a bank's real estate loan portfolio, examiners should review lending policies, loan-administration procedures, and credit-risk control procedures, as well as the bank's compliance with its own policies.

As mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) (12 USC 1828(c)), the Federal Reserve Board, along with the other banking agencies, adopted in December 1992 uniform regulations prescribing standards for real estate lending. FDICIA defines real estate lending as extensions of credit secured by liens on or interests in real estate that are made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property.

The Federal Reserve's Regulation H requires an institution to adopt real estate lending policies that are—

- consistent with safe and sound banking practices,
- appropriate to the size of the institution and the nature and scope of its operations, and
- reviewed and approved by the bank's board of directors at least annually.

These lending policies must establish—

- loan portfolio diversification standards;
- prudent underwriting standards that are clear and measurable, including loan-to-value limits;
- loan-administration procedures for the institution's real estate portfolio; and
- documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

Furthermore, the bank is expected to monitor conditions in the real estate market in its lending area to ensure that its policies continue to be appropriate for current market conditions.

GUIDELINES ESTABLISHED PURSUANT TO FDICIA

The criteria and specific factors that a bank should consider in establishing its real estate lending policies are set forth in the Interagency Guidelines for Real Estate Lending Policies (Regulation H, part 208, appendix C (12

CFR 208, appendix C)). These guidelines apply to transactions (including legally binding, but unfunded, lending commitments) originated on or after March 19, 1993.

Loan Portfolio Management

The bank's lending policies should contain a general outline of its market area; a targeted loan portfolio distribution; and the manner in which real estate loans are made, serviced, and collected. Lending policies should include—

- identification of the geographic areas in which the bank will consider lending;
- establishment of a loan portfolio diversification policy and limits for real estate loans by type and geographic market (for example, limits on higher-risk loans);
- identification of the appropriate terms and conditions, by type of real estate loan;
- establishment of loan-origination and -approval procedures, both generally and by size and type of loan;
- establishment of prudent underwriting standards, including loan-to-value (LTV) limits, that are clear and measurable and consistent with the supervisory LTV limits contained in the interagency guidelines;
- establishment of review and approval procedures for exception loans, including loans with LTV ratios in excess of the interagency guidelines' supervisory limits;
- establishment of loan-administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review;
- establishment of real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation and guidelines; and
- a requirement that management monitor the loan portfolio and provide timely and adequate reports to the bank's board of directors.

The complexity and scope of these policies and procedures should be appropriate for the market, size, and financial condition of the institution and should reflect the expertise and size of the lending staff. The bank's policies should also consider the need to avoid undue concentrations of risk and compliance with all real estate–related laws and regulations (such as the Community Reinvestment Act, the Truth in Lending Act, the Real Estate Settlement Procedures Act, and antidiscrimination laws).

On December 13, 2013, the "Interagency Statement on Supervisory Approach for Qualified and Non-Qualified Mortgage Loans" 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 (CFPB's) Ability-to-Repay and Qualified Mortgage Standards Rule[1] was issued on January 10, 2013 (effective on January 10, 2014). Institutions may issue qualified mortgages or non-qualified mortgages, based on their business strategies and risk appetites. Residential mortgage loans will not be subject to safety-and-soundness criticism based on their status as either qualified mortgages or non-qualified mortgages. As for safety-and-soundness expectations, the agencies[2] continue to expect institutions to underwrite residential mortgage loans in a prudent fashion and 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 and its attachment.

The bank should monitor the conditions in the real estate markets in its lending area so that it can react quickly to changes in market conditions that are relevant to the lending decision. This should include monitoring market supply-and-demand factors, such as employment trends; economic indicators; current and projected vacancy, construction, and absorption rates; and current and projected lease terms, rental rates, and sales prices.

1. 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.

2. The federal financial institutions regulatory agencies (the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration).

Underwriting Standards

The bank's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. These factors include—

- the capacity of the borrower or income from the underlying property to adequately service the debt;
- the market value of the underlying real estate collateral;
- the overall creditworthiness of the borrower,
- the level of the borrower's equity invested in the property;
- any secondary sources of repayment; and
- any additional collateral or credit enhancements, such as guarantees, mortgage insurance, or takeout commitments.

While there is no one lending policy appropriate for all banks, there are certain standards that a bank should address in its policies, such as—

- the maximum loan amount by type of property,
- the maximum loan maturities by type of property,
- amortization schedules,
- the pricing structure for each type of real estate loan, and
- loan-to-value limits by type of property.

For development and construction projects and completed commercial properties, the bank's policy should also establish appropriate standards for the unique risks associated with these types of real estate loans by addressing the size, type, and complexity of the project. Such standards should include the acceptability of and limits for nonamortizing loans and interest reserves; requirements for pre-leasing and presale; limits on partial recourse or nonrecourse loans; requirements for guarantor support; requirements for takeout commitments; and minimum covenants for loan agreements. Furthermore, the bank's policy should set minimum requirements for initial investment by the borrower; maintenance of hard equity throughout the life of the project; and net worth, cash flow, and debt-service coverage of the borrower or underlying property.

Exceptions to Underwriting Standards

The bank should have procedures for handling loan requests from creditworthy borrowers whose credit needs do not conform with the bank's general lending policy. As a part of the permanent loan file, the bank should document justification for approving such loans. Moreover, in the course of monitoring compliance with its own real estate lending policy, bank management should report to its board of directors loans of a significant size that are exceptions to bank policy. An excessive volume of exceptions to the institution's own policies may signal weaknesses in its underwriting practices or a need to revise its policy.

Supervisory Loan-to-Value Limits

The bank should establish its own internal loan-to-value (LTV) limits for each type of real estate loan that is permitted by its loan policy. The LTV ratio is derived at the time of loan origination by dividing the extension of credit, including the amount of all senior liens on, or other senior interests in, the property, by the total value of the property or properties securing or being improved by the extension of credit, plus the amount of any other acceptable collateral and readily marketable collateral securing the credit.

In accordance with the Federal Reserve's appraisal regulation and guidelines, the value of the real estate collateral should be set forth in an appraisal or evaluation (whichever is appropriate) and should be expressed in terms of market value. However, for loans to purchase an existing property, the term "value" means the lesser of the actual acquisition cost to the borrower or the estimate of value as presented in the appraisal or evaluation. See "Real Estate Appraisals and Evaluations," section 4140.1 of this manual for further discussion of the Federal Reserve's appraisal regulation and guidelines.

"Other acceptable collateral" refers to any collateral in which the lender has a perfected security interest, that has a quantifiable value, and that is accepted by the lender in accordance with safe and sound lending practices. This includes inventory, accounts receivables, equipment, and unconditional irrevocable standby letters of credit.

Readily marketable collateral means insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be readily salable under ordinary circumstances at a market value determined by quotations based on actual transactions, on an auction, or similarly available daily bid and asking price.

Other acceptable collateral and readily marketable collateral should be appropriately discounted by the lender consistent with the bank's usual practices for making loans secured by such collateral. The lender may not consider the general net worth of the borrower, which might be a determining factor for an unsecured loan, as equivalent to other acceptable collateral for determining the LTV on a secured real estate loan. Furthermore, if an institution attempts to circumvent the supervisory LTV limits by lending a portion of the funds on a secured basis and a portion on an unsecured basis, examiners are instructed to consider the two loans as one if certain similarities are found. These similarities are based upon facts such as common origination dates or loan purposes, and should be used to determine compliance with the supervisory LTV limits. The bank's policy should reflect the supervisory limits set forth in the Interagency Guidelines for Real Estate Lending Policies, which are shown in the following table.

Table 1—Supervisory Loan-to-Value Limits

Loan Category	*Loan-to-Value Limit*
Raw land	65%
Land development, including improved land loans	75%
Construction:	
Commercial, multifamily, and other nonresidential	80%
One- to four-family residential	85%
Improved property	85%
Owner-occupied one- to four-family and home equity	**

** A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied one- to four-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

For purposes of these supervisory limits, the loan categories are defined as follows:

Raw land loan means an extension of credit in which the funds are used to acquire and/or hold raw land.

Land development loan means an extension of credit for the purpose of improving unimproved real property before the erection of any structures. Such improvements include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development. This loan category also includes an extension of credit for the acquisition of improved land, such as residential lots in an established development. If there are minimal improvements to the land, and the time-frame for construction of the dwelling or building has not been scheduled to commence in the foreseeable future, the loan generally should be considered a raw land loan.

Construction loan means an extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

One- to four-family residential loan means an extension of credit for a property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property.

Multifamily construction loan means an extension of credit for a residential property containing five or more individual units, including condominiums and cooperatives.

Improved property loan refers to (1) farmland, ranchland, or timberland committed to ongoing management and agricultural production; (2) one- to four-family residential property that is not owner-occupied; (3) residential property containing five or more individual dwelling units; (4) completed commercial property; or (5) other income-producing property that has been completed and is available for occupancy and use, except income-producing owner-occupied one- to four-family residential property.

Owner-occupied one- to four-family residential property means that the owner of the underlying real property occupies at least one unit of the real property as a principal residence.

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project. For example, when the loan is for the acquisition and development of land and the construction of an office building in continuous phases of development, the appropriate supervisory LTV limit for the project loan would be 80 percent (the supervisory LTV limit for commercial construction). However, this does not imply that the lender can finance the total acquisition cost of the land at the time the raw land is acquired by assuming that this financing would be less than 80 percent of the project's final value. The lender is expected to fund the loan according to prudent disbursement procedures that set appropriate levels for the borrower's hard equity contributions throughout the disbursement period and term of the loan. As a general guideline, the funding of the initial acquisition of the raw land should not exceed the 65 percent supervisory LTV limit; likewise, the project cost to fund the land development phase of the project should not exceed the 75 percent supervisory LTV limit.

For a multiple-phase one- to four-family residential loan in which the lender is funding both the construction of the house and the permanent mortgage to a borrower who will be the owner-occupant, there is no supervisory LTV limit. However, if the LTV ratio equals or exceeds 90 percent, the bank should require an appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

When a loan is fully cross-collateralized by two or more properties, the maximum loan amount is determined by first multiplying each property's collateral value by the LTV ratio appropriate to that property and then deducting from that product any existing senior liens on that property. The resulting sum is the maximum loan amount that may be extended under cross-collateralization. To ensure that collateral margins remain within the supervisory limits, the bank should redetermine conformity whenever collateral substitutions are made to the collateral pool.

Loans in Excess of Supervisory LTV Limits

The Federal Reserve believes that it may be appropriate for a bank, in certain circumstances, to originate or purchase loans with LTV ratios in excess of supervisory limits, based on the support provided by other credit factors that the bank documented in its permanent credit files. While high LTV lending poses higher risk for lenders than traditional mortgage lending, high LTV lending can be profitable when these risks are effectively managed and loans are priced based on risk. Therefore, institutions involved in high LTV lending should implement risk-management programs that identify, measure, monitor, and control the inherent risks (see SR-99-26 and the attached "Interagency Guidance on High LTV Residential Real Estate Lending," October 8, 1998). The primary credit risks associated with this type of lending are increased default risk and losses, inadequate collateral, longer term and thus longer exposure, and limited default remedies.

Capital limits. A bank's nonconforming loans—those in excess of the supervisory LTV limits—should be identified in bank records, and the aggregate amount, along with the performace experience of the portfolio, should be reported at least quarterly to the bank's board of directors. There should be increased supervisory scrutiny of a bank as its level of loans in excess of supervisory LTV limits approaches the capital limitations. Nevertheless, a nonconforming loan should not be criticized solely because it does not adhere to supervisory limits.

The aggregate amount of nonconforming loans may not exceed 100 percent of a bank's total risk-based capital (referred to as the nonconforming basket). Within this limit, the aggregate amount of non–one- to four-family residential loans (for example, raw land, commercial, multifamily, and agricultural loans) that do not conform to supervisory LTV limits may not exceed 30 percent of total risk-based capital. The remaining portion of the nonconforming basket includes the aggregate amount of one- to four-family residential development and construction loans, non-owner-occupied one- to four-family residential loans with an LTV ratio greater than 85 percent, and owner-occupied one- to four-family residential loans with an LTV ratio equal to or exceeding 90 percent without mortgage insurance or readily marketable collateral.

For the purpose of determining the loans subject to the 100 percent of risk-based capital limitation, and for the purposes of determining the aggregate amount of such loans, institutions should include loans that are secured by the *same* property, when the combined loan amount equals or exceeds 90 percent LTV and there is no additional credit support. In addition, institutions should include the recourse obligation of any such loan sold with recourse. If there is a reduction in principal or senior liens or if the borrower contributes additional collateral or equity that brings the LTV ratio into supervisory compliance, the loan is no longer considered nonconforming and may be deleted from the quarterly nonconforming loan report to the directors.

The following guidance is provided for calculating the LTV when multiple loans and more than one lender are involved. The institution should include its loan and all senior liens on or interests in the property in the total loan amount when calculating the LTV ratio. The following examples are provided:

- Bank A holds a first-lien mortgage on a property and subsequently grants the borrower a home equity loan secured by the same property. In this case, the bank would combine both loans to determine if the total amount outstanding equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, the entire amount of both loans is an exception to the supervisory LTV limits and is included in the aggregate capital limitation.
- Bank A grants a borrower a home equity loan secured by a second lien. Bank B holds a first-lien mortgage for the same borrower and on the same property. Bank A would combine the committed amount of its home equity loan with the amount outstanding on Bank B's first-lien mortgage to determine if the LTV ratio equaled or exceeded 90 percent of the property's market value. If the LTV ratio equals or exceeds 90 percent and there is no other appropriate credit support, Bank A's entire home equity loan is an exception to the supervisory LTV limits and is included in the aggregate capital limitation. Bank A does not report Bank B's first-lien mortgage loan as an exception, but must use it to calculate the LTV ratio.

When a loan's LTV ratio is reduced below 90 percent by amortization or additional credit support, it is no longer an exception to the guidelines and may be excluded from the institution's 100 percent of capital limitation.

Institutions will come under increased supervisory scrutiny as the total of all loans in excess of the supervisory LTV limits, including high-LTV residential real estate loan exceptions, approaches 100 percent of total capital. If an institution exceeds the 100 percent of capital limit, a supervisory assessment may be needed to determine whether there is any concern that warrants taking appropriate supervisory action. Such action may include directing the institution (1) to reduce its loans in excess of the supervisory LTV limits to an appropriate level, (2) to raise additional capital, or (3) to submit a plan to achieve compliance. The institution's capital level and overall risk profile, and the adequacy of its controls and operations, as well as other factors will be the basis for determining whether such actions are necessary.

Transactions Excluded from Supervisory LTV Limits

There are a number of lending situations in which other factors significantly outweigh the need to apply supervisory LTV limits, thereby excluding such transactions from the application of the supervisory LTV and capital limits. This includes loans—

- guaranteed or insured by the U.S. government or its agencies, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- backed by the full faith and credit of a state government, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit.
- guaranteed or insured by a state, municipal, or local government or agency, provided the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the supervisory LTV limit and that the guarantor or insurer has the financial capacity and willingness to perform.
- sold promptly (within 90 days) after origination. A supervisory determination may be made that this exclusion is not available for an institution that has consistently demonstrated significant weaknesses in its mortgage banking operations. (If a loan is sold with recourse and the LTV is in excess of supervisory limits, the recourse portion of the loan counts toward the bank's limit for nonconforming loans.)
- renewed, refinanced, or restructured—
  - without the advancement of new monies (except reasonable closing costs); or
  - in conjunction with a clearly defined and documented workout, either with or without the advancement of new funds.
- facilitating the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith.
- in which a lien on real property is taken through an abundance of caution; for example, the value of the real estate collateral is relatively low compared with the aggregate value of other collateral, or a blanket lien is taken on all or substantially all of the borrower's assets.[3]
- for working-capital purposes in which the lender does not rely principally on real estate as security. The proceeds of the loan are not used to acquire, develop, or construct real property.
- financing permanent improvements to real property, but in which no security interest is taken or required by prudent underwriting standards. For example, a manufacturing company obtains a loan to build an addition to its plant. The bank does not take a lien on the plant because the bank is relying on the company's operating income and financial strength to repay the debt.

3. Any residential mortgage or home equity loan with an LTV ratio that equals or exceeds 90 percent and that does not have the additional credit support should be considered an exception to the guidelines and included in the calculation of loans subject to the 100 percent of capital limit.

Risk Management for Supervisory Loan-to-Value Limits

Loan review and monitoring. Institutions should perform periodic quality analyses through loan review and portfolio monitoring. These periodic reviews should include an evaluation of various risk factors, such as credit scores, debt-to-income ratios, loan types, location, and concentrations. At a minimum, the high-LTV loan portfolios should be segmented by their vintage (that is, age) and the performance of the portfolios should be analyzed for profitability, growth, delinquencies, classifications and losses, and the adequacy of the allowance for loan and lease losses based on the various risk factors. The ongoing performance of the high-LTV loans should be monitored by a periodic re-scoring of the accounts, or by periodically obtaining updated credit bureau reports or financial information on borrowers. In addition, institutions involved in high-LTV lending should adopt, as part of their loan-review program, the standards in the FFIEC's Uniform Retail-Credit Classification and Account-Management Policy. (See section 2130.1.)

Sales of high-LTV loans. When institutions securitize and sell high-LTV loans, all the risks inherent in such lending may not be transferred to the purchasers. Institutions that actively securitize and sell high-LTV loans must implement procedures to control the risks inherent in that activity. Only written counterparty agreements that specify the duties and responsibilities of each party and that include a regular schedule for loan sales should be entered into. A contingency plan should be developed that designates backup purchasers and servicers in the event that either party is unable to meet its contractual obligations. To manage liquidity risk, commitment limits should be established for the amount of pipeline and warehoused loans, and alternate funding sources should be identified.

Institutions should refer to the Financial Accounting Standards Board's Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (a replacement of FASB statement 125)," for guidance on accounting for these types of transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations.

Compliance risk. Institutions that originate or purchase high-LTV real estate loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to high-LTV products for reasons other than the borrower's creditworthiness. An adequate compliance-management program must identify, monitor, and control the compliance risks associated with high-LTV real estate lending.

REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (primarily construction loans) and permanent financing (for example, a 30-year residential mortgage or a 10-year mortgage loan with payments based on a 25-year amortization schedule and a balloon payment due at the end of the 10 years on an existing commercial office building). Each type of lending carries with it unique underwriting risks as well as common risks associated with any type of lending. In all cases, the bank should understand the credit risks and structure of the proposed transaction, even if it is not the originating bank. This includes, at a minimum, understanding the borrower's ability to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long term and presents a funding risk since a bank's source of funds is generally of a shorter maturity. Accordingly, bank management should be aware of the source for funding this lending activity. While matching the maturity structures of assets to liabilities is particularly important for a bank's overall loan portfolio management, the importance of this task is even more evident in real estate lending activity. Many banks reduce their funding risk by entering into loan participations and sales with other institutions as well as asset securitization transactions.[4] For a detailed discussion on short-term financing, see section 2100.1, "Real Estate Construction Loans."

Unsound Lending Practices

Some banks have adversely affected their financial condition and performance by granting loans based on ill-conceived real estate projects. Apart from losses due to unforeseen economic downturns, these losses have generally been the result of poor or lax underwriting standards and improper management of the bank's overall real estate loan portfolio.

A principal indication of an unsound lending practice is an improper relationship between the loan amount and the market value of the property; for example, a high loan-to-value ratio in relationship to normal lending practice for a similar type of property. Another indication of unsound lending practices is the failure of the bank to examine the borrower's debt-service ability. For a commercial real estate loan, sound underwriting practices are critical to the detection of problems in the project's plans, such as unrealistic income assumptions, substandard project design, potential construction problems, and a poor marketing plan, that will affect the feasibility of the project.

Real Estate Loan Portfolio Concentration Risk

A bank should have in place effective internal policies, systems, and controls to monitor and manage its real estate loan portfolio risk. An

4. See section 4030.1, "Asset Securitization," for additional information, including information on mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs).

indication of improper management of a bank's portfolio is an excessive concentration in loans to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the bank's designated trade area.

In identifying loan concentrations, commercial real estate loans and residential real estate loans should be viewed separately when their performance is not subject to similar economic or financial risks. However, groups or classes of real estate loans should be viewed as concentrations when there are significant common characteristics and the loans are affected by similar adverse economic, financial, or business developments. Banks with asset concentrations should have in place effective internal policies, systems, and controls to monitor and manage this risk.

Concentrations that involve excessive or undue risks require close scrutiny by the bank and should be reduced over a reasonable period of time. To reduce this risk, the bank should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans. At the same time, the bank should maintain adequate capital to protect it from the excessive risk while restructuring its portfolio.

Loan Administration and Servicing

Real estate loan administration is responsible for certain aspects of loan monitoring. While the administration may be segregated by property type, such as residential or commercial real estate loans, the functions of the servicing department may be divided into the following categories (although the organization will vary among institutions):

- *Loan closing and disbursement*—preparing the legal documents verifying the transaction, recording the appropriate documents in the public land records, and disbursing funds in accordance with the loan agreement.
- *Payment processing*—collecting and applying the loan payments.
- *Escrow administration*—collecting insurance premiums and property taxes from the borrower and remitting the funds to the insurance company and taxing authority.
- *Collateral administration*—maintaining documents to reflect the status of the bank's lien on the collateral (i.e., mortgage/deed of trust and title policy/attorney's opinion), the value of the collateral (i.e., real estate appraisal or evaluation and verification of senior lien, if in existence), and the protection of the collateral (i.e., hazard/liability insurance and tax payments).
- *Loan payoffs*—determining the pay-off amount, preparing the borrower release or assumption documents, confirming the receipt of funds, and recording the appropriate lien-release documents in the public land records.
- *Collections and foreclosure*—monitoring the payment performance of the borrower and pursuing collection of past-due amounts in accordance with bank policy on delinquencies.
- *Claims processing*—seeking recoveries on defaulted loans that are covered by a government guarantee or insurance program or a private mortgage insurance company.

The bank should have adequate procedures to ensure segregation of duties for disbursal and receipt of funds control purposes. Additionally, the procedures should address the need for document control because of the importance of the timely recording of the bank's security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from solely the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the bank will have the additional responsibility of remitting funds on a timely basis to the other institutions in accordance with a servicing agreement. The servicing agreement sets forth the servicer's duties, reporting requirements, timeframe for remitting funds, and fee structure. If a bank relies on another institution for servicing, the bank should have adequate control and audit procedures to verify the performance of the servicer (also see section 4030.1, "Asset Securitization"). For residential loans sold into the secondary mortgage market for which the bank has retained servicing, Fannie Mae, Freddie Mac, and the Government National Mortgage Corporation (Ginnie Mae) have specific standards the bank (that is, seller/servicer) must adhere to. Failure to meet these standards can result in the termination of the servicing agreement.

BANK ASSESSMENT OF THE BORROWER

Although the value of the real estate collateral is an important component of the loan-approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate assessment of the borrower's ability to repay the loan. These assessment factors differ depending upon the purpose of the loan, such as single-family residential loans as compared with income-producing commercial property loans and commercial or residential development loans (referred to as "commercial real estate lending"). The loan documentation must adequately support the bank's assessment of the borrower and contain the appropriate legal documentation to protect the bank's interests.

Single-Family Residential Loans

For single-family residential loans, the bank should evaluate the loan applicant's creditworthiness and whether the individual has the ability to meet monthly mortgage payments as well as all other obligations and expenses associated with home ownership. This includes an assessment of the borrower's income, liquid assets, employment history, credit history, and existing obligations.[5] The bank should also consider the availability of private mortgage insurance; a government guarantee; or a government insurance program, such as loans through the FHA-insured or VA-guaranteed programs, in assessing the credit risk of a loan applicant.

If a bank delegates the loan-origination function to a third party, the bank should have adequate controls to ensure that its loan policies and procedures are being followed. The controls should include a review of the third party's qualifications; a written agreement between the bank and the third-party originator to set forth the responsibilities of the third party as an agent for the bank; a periodic review of the third party's operations to ensure that the bank's policies and procedures are being adhered to; and development of quality controls to ensure that loans originated by the third party meet the bank's lending standards, as well as those of the secondary mortgage market if the bank expects to sell the mortgages.

5. There are restrictions on the information a bank can request. The Federal Reserve's Regulation B, Equal Credit Opportunity (12 CFR 202), details the information that may and may not be requested on a loan application and provides a model form for a residential mortgage transaction. The Federal Reserve's Regulation Z, Truth in Lending (12 CFR 226), describes the bank-disclosure requirements to the potential borrower on the cost of financing.

Abandoned Residential Real Estate Foreclosures

Banking organizations with residential mortgage-servicing operations should ensure that the following key concepts are addressed in their policies and practices governing the decision not to complete foreclosure proceedings after they have been initiated (abandoned foreclosures):

- *Notification to borrowers.* Supervised banking organizations should notify the borrower(s) when a decision is made not to pursue a foreclosure action, and should inform the applicable borrower(s) of their (1) rights to occupy their property until a sale or other title transfer action occurs, (2) financial obligations regarding the outstanding loan balance and the payment of applicable taxes and insurance premiums, and (3) property maintenance responsibilities.
- *Communications.* Supervised banking organizations should use all means possible to provide the notification described above to affected borrowers, particularly those who prematurely vacated their homes based on the servicers' initial communications regarding foreclosure actions. In particular, when attempting to provide the notification, supervised organizations should employ the same extensive methods they use to contact borrowers in connection with payment collection activities.
- *Notification to local authorities.* Supervised banking organizations should ensure that their procedures include reasonable efforts to notify appropriate state or local government authorities of the organization's decision to not pursue a foreclosure, including complying with applicable state or local government notification requirements. These local entities may include tax authorities, courts, or code enforcement departments.
- *Obtaining and monitoring collateral values.* Supervised banking organizations should have a process for obtaining the best practicable information on the collateral value of a residential property that may be subject to fore-

closure; updating this information on a regular basis; and using current information in their assessment as to whether to initiate, continue, or abandon a foreclosure proceeding.[6]

Supervisory Process

The objective of the supervisory process related to abandoned foreclosures is to confirm that a banking organization manages its decisions to initiate and/or discontinue foreclosure proceedings in a prudent manner. Examiners are to determine if an organization's policies and procedures include regular monitoring of property values. This review may be done as part of the regular assessments of banking organizations' appraisal and evaluation programs. (See SR-12-11/CA-12-10.)

Secondary Residential Mortgage Market

In the secondary market, a bank (the primary mortgage originator) sells all or a portion of its interest in residential mortgages to other financial institutions (investors). Thus, the secondary mortgage market provides an avenue for a bank to liquidate a long-term asset as the need for funds arises. The majority of the secondary mortgage market activity is supported by three government-related or -controlled institutions: Fannie Mae,[7] Freddie Mac,[8] and Ginnie Mae.[9] These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. Fannie Mae, Freddie Mac, and Ginnie Mae have specific underwriting standards and loan-documentation requirements for mortgages purchased or guaranteed by them. Generally, financial institutions enter into either a mandatory or a standby commitment agreement with these entities wherein the financial institution agrees to sell loans according to certain delivery schedules, terms, and performance penalties.

Commercial Real Estate Loans

As with other types of lending activities, the extent of commercial real estate lending activity should be contingent upon the lender's expertise and the bank's experience. In considering an application for a commercial real estate loan, a bank should understand the relationship of the actual borrower to the project being financed. The form of business ownership varies for commercial real estate projects and can affect the management, financial resources available for the completion of the project, and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the bank assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the bank should closely review the project's feasibility study. The study should provide sensitivity and risk analyses of the potential impact of changes in key economic variables, such as interest rates, vacancy rates, or operating expenses. The bank should also conduct credit checks of the borrower and of all principals involved in the transaction to verify relationships with contractors, suppliers, and business associates.

Finally, the bank should assess the borrower's financial strength to determine if the principals of the project have the necessary working capital and financial resources to support the project until it reaches stabilization. As with any type of lending on income-producing properties,[10] the bank should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any

6. Refer to section 4140.1 or SR-10-16, "Interagency Appraisal and Evaluation Guidelines," for supervisory expectations as to a regulated banking organization's policies and procedures on collateral monitoring in support of its loan modification or workout activity.

7. Although Fannie Mae was originally created in 1938 as an organization within the federal government, it became a federally chartered, stockholder corporation in 1968 when some of its functions were placed under the newly created Ginnie Mae. Financial institutions can either sell mortgages directly to Fannie Mae or pool mortgages for placement in a Fannie Mae–guaranteed mortgage-backed security.

8. Freddie Mac was sponsored by the Federal Home Loan Bank Board and its members in 1970. Its primary purpose is to provide a secondary market for conventional mortgages originated by thrifts.

9. Ginnie Mae, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when Fannie Mae became a private corporation. It has several functions to assist in government housing programs, such as managing and liquidating loans acquired by the government. In the secondary market, Ginnie Mae acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

10. Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels.

guarantees or other collateral that may be available as a source of loan repayment.

BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate–related financial transactions before making the final credit or other decision. The Federal Reserve's appraisal regulation requires institutions to obtain appraisals when certain criteria are met. See "Real Estate Appraisals and Evaluations" section 4140.1, for a description of the related requirements a bank must follow for real estate–related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale for accepting and relying upon the appraisal or evaluation should be documented in writing. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation.

Single-Family Residential Loans

The assessment of a residential property's market value is critical to the bank's estimate of loan-to-value ratio. This assessment provides the bank with an estimate of the borrower's equity in the property and the bank's potential credit risk if the borrower should default on the loan. For mortgages over $250,000, a bank is required to obtain an appraisal in conformance with the Federal Reserve's appraisal regulation. As of January 1, 1993, the appraisal must be performed by a state-certified or -licensed appraiser, as specified in the regulation. While transactions under $250,000 do not require an appraisal, a bank is expected to perform an appropriate evaluation of the underlying real estate collateral. Loans that are wholly or partially insured or guaranteed by a U.S. government agency or government-sponsored agency are exempt from the Federal Reserve's appraisal regulation, so long as the loan meets the underwriting requirements of the federal insurer or guarantor. Additionally, state laws for appraisals may differ from the Federal Reserve's requirements.

Loans qualifying for sale to any U.S. government agency or government-sponsored agency or conforming to the appraisal standards of Fannie Mae and Freddie Mac are also exempt from the Federal Reserve's appraisal regulation. Fannie Mae and Freddie Mac jointly developed and adopted the Uniform Residential Appraisal Report (URAR) as the standard form for residential loans sold to them. As a result, a properly completed URAR form is considered the industry standard for appraising one- to four-family residential properties.

Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is not a uniformly accepted format for valuing commercial properties like there is for valuing one- to four-family residential properties. A bank relies on outside appraisers, or in some instances in-house expertise, to prepare appraisals. For the most part, appraisals on commercial real estate projects are presented in a narrative format with supporting schedules. As the complexity of a commercial project increases, the detail of the appraisal report or evaluation should also increase to fully support the analysis.

When estimating the value of income-producing real estate, the appraiser generally relies to a greater degree on the income approach to valuation than on the comparable-sales approach or the cost approach. The income approach converts all expected future net operating income into present-value terms, using different analytical methods. One method, known as the direct capitalization method, estimates the present value of a property by discounting its stabilized net operating income at an appropriate capitalization rate (commonly referred to as a cap rate). Stabilized net operating income is the net cash flow derived from a property when market conditions are stable and no unusual patterns of future rents and occupancy are expected. To approximate stabilized net operating income, the appraiser or bank may need to adjust the current net operating income of a property either up or down to reflect current market conditions. The direct capitalization method is appropriate only for use in valuing stabilized properties.

Another method, known as the discounted cash-flow method, requires the discounting of expected future cash flows at an appropriate discount rate to ascertain the net present value of a property. This method is appropriate for use in estimating the values of new properties that have not yet stabilized, or for troubled properties that are experiencing fluctuations in income.

The discount rates and cap rates, used in estimating property values, should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used in the appraisal. The appraiser should not use exaggerated, imprudent, or unsustainably high or low discount rates, cap rates, or income projections.

In assessing the reasonableness of the facts and assumptions associated with the valuation of commercial real estate, the bank should consider—

- current and projected vacancy and absorption rates;
- lease-renewal trends and anticipated rents;
- volume and trends in past-due leases;
- the project's feasibility study and market survey to determine support for the assumptions concerning future supply-and-demand factors;
- effective rental rates or sale prices (taking into account all concessions);
- net operating income of the property as compared with budget projections; and
- discount rates and direct capitalization rates.

Because the income approach is generally relied on to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the bank must use judgment in determining the time it will take for a property to achieve stabilized occupancy and rental rates. The analysis of collateral values should not be based on a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions.

The capacity of a property to generate cash flow to service a loan is evaluated on the basis of rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy, rental rates, and net operating income should be based on an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate.

EARLY INDICATIONS OF TROUBLED COMMERCIAL REAL ESTATE LOANS

Market-Related

To evaluate the collectibility of their commercial real estate portfolio, banks should be alert for economic indicators of weakness in their real estate markets as well as for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators useful in evaluating the condition of the local real estate market include permits for and the value of new construction, absorption rates, employment trends, vacancy rates, and tenant lease incentives. Weaknesses disclosed by these types of statistics may signify that a real estate market is experiencing difficulties that may cause cash-flow problems for individual real estate projects, declining real estate values, and ultimately, troubled real estate loans.

Project-Related

Characteristics of potential or actual difficulties in commercial real estate projects may include—

- an excess supply of similar projects under construction in the same trade area.
- the lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.
- changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).

- rent concessions or sales discounts, resulting in cash flow below the level projected in the original feasibility study, appraisal, or evaluation.
- concessions on finishing tenant space, moving expenses, and lease buyouts.
- slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.
- delinquent lease payments from major tenants.
- land values that assume future rezoning.
- tax arrearages.
- environmental hazards and liability for cleanup.

As the problems associated with a commercial real estate loan become more pronounced, the borrower/guarantor may experience a reduction in cash flow to service-related debts, which could result in delinquent interest and principal payments.

While some real estate loans become troubled because of a general downturn in the market, others become troubled because the loans were originated on an unsound or a liberal basis. Common examples of unsound loans include—

- loans with no or minimal borrower equity
- loans on speculative undeveloped property in which the borrower's only source of repayment is the sale of the property
- loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value
- additional advances to service an existing loan without evidence that the loan will be repaid in full
- loans to borrowers with no development plans or noncurrent development plans
- renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule[11]

EXAMINER REVIEW OF COMMERCIAL REAL ESTATE LOANS

The focus of an examiner's review of a real estate loan is on the ability of the loan to be repaid. The principal factors that bear on this review are the income-producing potential of the underlying collateral and the borrower's willingness and ability to repay the loan from other resources, if necessary, and according to existing loan terms. In evaluating the overall risk associated with a real estate loan, examiners should consider a number of factors, including the borrower's character, overall financial condition and resources, and payment history; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[12] As the borrower's and guarantor's ability to repay a troubled real estate loan decreases, the importance of the collateral value of the loan increases commensurately.

Examiner Review of the Real Estate Collateral

An examiner's analysis of the collateral value is based on the bank's most recent appraisal or evaluation and includes a review of the major facts, assumptions, and approaches used by the appraiser or person performing the evaluation (including any comments made by management relative to the reasonableness of the appraisal or evaluation assumptions and conclusions). While the examiner may make adjustments to the assessment of value, these adjustments should be made solely for purposes of an examiner's analysis and assessment of credit quality and should not involve an adjustment to the actual appraisal or evaluation.

Furthermore, examiners should not make adjustments to appraisal or evaluation assumptions for credit-analysis purposes based on worst-

11. As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. As consistent with sound banking practices, institutions should work appropriately and constructively with borrowers who may be experiencing temporary difficulties.

12. The primary basis for the review and classification of the loan should be the original source of repayment and the borrower's intent and ability to fulfill the obligation without relying on third-party guarantees. However, the examiner should also consider the support provided by any guarantees when determining the appropriate classification treatment for a troubled loan. The treatment of guarantees in the classification process is discussed in "Classification of Credits," section 2060.1.

case scenarios that are unlikely to occur. For example, an examiner should not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit-analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

Assumptions, when recently made by qualified appraisers or persons performing the evaluation and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and cap rates used in appraisals or evaluations, that differ only in a limited way from norms that would generally be associated with the property under review. However, the estimated value of the underlying collateral may be adjusted for credit-analysis purposes when the examiner can establish that underlying facts or assumptions are inappropriate and can support alternative assumptions.

CLASSIFICATION GUIDELINES

As with other types of loans, real estate loans that are adequately protected by the current sound worth and debt-service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. The examiner should focus on the ability of the borrower, guarantor, or the collateral to provide the necessary cash flow to adequately service the loan. The loan's record of performance is also important and must be taken into consideration. As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.[13]

Similarly, loans to sound borrowers that are refinanced or renewed according to prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be categorized as special mention unless potential weaknesses exist or should not be classified unless well-defined weaknesses exist that jeopardize repayment. An institution should not be criticized for working with borrowers whose loans are classified or categorized as special mention as long as the institution has a well-conceived and effective workout plan for such borrowers, along with effective internal controls to manage the level of these loans.

In evaluating real estate credits for special-mention categorization or classification, examiners should apply the standard definitions as set forth in "Classification of Credits," section 2060.1. In assessing credit quality, examiners should consider all important information regarding repayment prospects, including information on the borrower's creditworthiness, the value of and cash flow provided by all collateral supporting the loan, and any support provided by financially responsible guarantors.

These guidelines apply to individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits in the same industry that are not affected by the problems of the troubled sectors.

13. Another issue that arises in the review of a commercial real estate loan is its accrual or nonaccrual treatment for reporting purposes. The federal banking agencies, under the auspices of the FFIEC, have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (call reports) and in related supervisory guidance of the agencies. This guidance is summarized in "Loan Portfolio Management," section 2040.1.

Troubled Project-Dependent Commercial Real Estate Loans

The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment. As a general principle, for a troubled project-dependent commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can be clearly identified as uncollectible, should be classified loss. The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than substandard. The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified doubtful when the potential for full loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. However, such a classification should occur infrequently.

Partially Charged-Off Loans

An evaluation based upon consideration of all relevant factors may indicate that a credit has well-defined weaknesses that jeopardize collection in full, although a portion of the loan may be reasonably assured of collection. When a charge-off has been taken in an amount sufficient to ensure that the remaining recorded balance of the loan (1) is being serviced (based upon reliable sources) and (2) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than substandard.

A more severe classification than substandard for the remaining recorded balance would be appropriate, however, if the loss exposure cannot be reasonably determined—for example, when significant risk exposures are perceived, such as in the case of bankruptcy or loans collateralized by properties subject to environmental hazards. In addition, classifying the remaining recorded balance more severely than substandard would be appropriate when sources of repayment are considered unreliable.

Formally Restructured Loans

The classification treatment previously discussed for a partially charged-off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable modified terms.[14] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit-review system and closely monitored by management.

Home Equity Loans

Home equity loans (HELs) are defined as loans that are usually collateralized by a second mortgage or deed of trust on the borrower's principal residence or second residence; however, the collateral may be a first mortgage or deed of trust. The borrower's equity in the residence, pledged as collateral, provides protection for the loan and determines the maximum amount of credit that may be advanced. Traditionally, HELs were used to fund home improvements or to consolidate debt, and they were usually amortized without a revolving feature. Because of these characteristics, home equity loans were commonly maintained and administered in a bank's consumer or installment loan department and were monitored based on delinquency status. However, since enactment of the Tax Reform Act of 1986, which allows the deduction of home equity loan interest on debt of up to $100,000, the popularity and usage of HELs

14. An example of a restructured commercial real estate loan that does not have reasonable modified terms would be a cash-flow mortgage, which requires interest payments only when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

have expanded considerably. The proceeds of home equity loans are now used for increasingly diverse purposes, such as to make consumer purchases or personal investments, to provide working capital for small businesses, and to supplement personal income.

The structure and repayment terms of home equity loans have become more varied. Amortization periods may be as long as 15 years, with possible balloon maturities of three to five years. In some instances, the payment requirement is only interest due for an initial period. Revolving lines of credit have also gained popularity as a way to accommodate the many different uses of loan proceeds. Lines of credit to individuals with high incomes or high net worths may substantially exceed $100,000. These loans are often housed in the bank's private-bankingdivision or within the commercial loan portfolio, rather than in the consumer loan department.

In addition to the increasingly varied purposes of HELs, there has also been an upsurge in loans in which the combined first and second mortgages result in very high LTV ratios. To remain competitive with other residential lenders, some banks have relaxed their underwriting standards by permitting higher LTV ratios. In addition, some banks may have offset declines in residential mortgage refinancing during periods of higher interest rates by competing more aggressively for home equity loan business. Consumer demand for HELs may also increase during periods of higher interest rates because they provide an alternative source of financing for consumer purchases.

Examiners must ensure that a bank's policies for originating and acquiring HELs comply with the real estate lending standards and guidelines stipulated in the Board's Regulation H, subpart E. (See Regulation H, subpart E, 12 CFR 208.50–51.) While the guidelines permit banks to make residential real estate loans with LTV ratios in excess of 90 percent without the appropriate credit enhancements, these loans are treated as exceptions to the guidelines and are subject to the aggregate limitation of 100 percent of the bank's total capital.

For all types of lending, banks should have strong underwriting standards for HELs. In assessing these standards, the examiner should determine whether the bank primarily emphasizes the borrower's ability and willingness to repay the loan from income or cash flow versus the amount of equity in the real estate. Extended repayment terms and liberal loan structures can increase the risk of default on HELs. Normally, longer repayment terms increase the likelihood of events that could jeopardize the borrower's ability to repay, for example, the loss of a job, a change in marital status, a prolonged spike in prevailing interest rates, or a deflationary economic environment. Additionally, the examiner should review the bank's policy (or practice) for obtaining appraisals or evaluations to determine the lendable equity in the borrower's residence. The examiner should determine that the bank has not relaxed its appraisal and evaluation requirements to accommodate the growth of its HEL portfolio.

Economic periods of increasing unemployment, rising interest rates, or other recessionary factors can negatively affect the repayment ability of borrowers and erode the value and marketability of residential real estate. Moreover, most HELs are collateralized by junior lien positions. Therefore, if the bank forecloses, it must pay off or service the senior mortgage lender, further increasing its exposure. Foreclosure proceedings may entail lengthy and costly litigation, and real estate law commonly protects the home owner.

Examiners should ensure that banks have proper controls to manage HEL exposure, particularly those banks that have a high concentration of home equity loans with excessively high combined LTV ratios. (See the following subsection for interagency guidance on credit-risk management in home equity lending.) Banks with concentrations that lack proper controls and monitoring procedures should be criticized for these credit deficiencies. If the examiner judges the deficiencies to be severe, the bank should be cited for unsafe and unsound banking practices.

Interagency Credit-Risk Management Guidance for Home Equity Lending

The Federal Reserve and the other federal financial institutions regulatory agencies[15] collec-

15. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration. Also, the interagency guidance frequently uses the term *financial institutions.* As used in this section, *financial institutions* means commercial banks and any of their various credit-extending nonbanking subsidiaries.

tively issued this interagency guidance on May 16, 2005. The guidance is intended to promote sound credit-risk management practices at financial institutionsthat have home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). Home equity lending can be an attractive product for many homeowners and lenders. The quality of these portfolios, however, is subject to increased risk if interest rates rise and home values decline. Sound underwriting practices and effective risk-management systems are essential to mitigate this risk. Therefore, financial institutions' credit-risk management practices for home equity lending need to keep pace with any rapid growth in home equity lending and should emphasize compliance with sound underwriting standards and practices.

The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that financial institutions need to fully recognize the risk embedded in their home equity portfolios. Following are the specific product, risk-management, and underwriting risk factors and trends that deserve scrutiny:

- interest-only features that require no amortization of principal for a protracted period
- limited or no documentation of a borrower's assets, employment, and income (known as "low doc" or "no doc" lending)
- higher loan-to-value (LTV) and debt-to-income (DTI) ratios
- lower credit-risk scores for underwriting home equity loans
- greater use of automated valuation models (AVMs) and other collateral-evaluation tools for the development of appraisals and evaluations
- an increase in the number of transactions generated through a loan broker or other third party

Home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk-management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral-valuation management, individual-account and portfolio management, and servicing.

Financial institutions should ensure that risk-management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for financial institutions that project or have already experienced significant growth or concentrations, particularly in higher-risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party-generated loans. (See SR-05-11.)

Credit-Risk Management Systems

Product Development and Marketing

In the development of any new product offering, product change, or marketing initiative, management should have a review and approval process that is sufficiently broad to ensure compliance with the financial institution's internal policies and applicable laws and regulations[16] and to evaluate the credit, interest-rate, operational, compliance, reputation, and legal risks. In particular, risk-management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material changes in the targeted market, origination source, or pricing could have a significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, financial institutions should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, see "Third-Party Originations.") Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to

16. Applicable laws include the Federal Trade Commission Act; the Equal Credit Opportunity Act (ECOA); the Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); the Fair Housing Act; the Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

increase a line, extend the interest-only period, or adjust the interest rate or term.

Origination and Underwriting

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the Federal Reserve's regulations on real estate lending standards,[17] prudently underwritten home equity loans should include an evaluation of a borrower's capacity to adequately service the debt.[18] Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.[19] Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

HELOCs generally do not have interest-rate caps that limit rate increases.[20] Rising interest rates could subject a borrower to significant payment increases, particularly in a low-interest-rate environment. Therefore, underwriting standards for interest-only and variable-rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

17. On December 23, 1992, the Federal Reserve announced the adoption of uniform rules on real estate lending standards and issued the Interagency Guidelines for Real Estate Lending Policies. See 12 CFR 208.51 and 12 CFR 208, appendix C.

18. See also section 226.34(a)(4) of Regulation Z, Truth in Lending (12 CFR 226.34(a)(4)).

19. The Interagency Guidelines Establishing Standards for Safety and Soundness also call for documenting the source of repayment and assessing the ability of the borrower to repay the debt in a timely manner. See 12 CFR 208, appendix D-1.

20. While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 CFR 226.30(b).

Third-Party Originations

Financial institutions often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, institutions should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

Brokers are firms or individuals, acting on behalf of either the financial institution or the borrower, who match the borrower's needs with institutions' mortgage-origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the financial institution and the broker. For control purposes, the financial institution should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

Correspondents are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Financial institutions commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a financial institution grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating financial institution should have systems and controls to provide assurance that the correspondent is appropriately managed, is financially sound, and provides mortgages that meet the financial institution's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality-control unit or function in the delegating financial institution should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities.

Both brokers and correspondents are compensated based upon mortgage-origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, financial institutions should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the financial institution should have adequate audit procedures and controls to verify that the third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.[21] Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the financial institution should take appropriate action against the third party, which could include terminating its relationship with the third party.

Collateral-Valuation Management

Competition, cost pressures, and advancements in technology have prompted financial institutions to streamline their appraisal and evaluation processes. These changes, coupled with financial institutions underwriting to higher LTVs, have heightened the importance of strong collateral-valuation management policies, procedures, and processes.

Financial institutions should have appropriate collateral-valuation policies and procedures that ensure compliance with the Federal Reserve's appraisal regulations[22] and the Interagency Appraisal and Evaluation Guidelines (the guidelines).[23] In addition, the financial institution should—

- establish criteria for determining the appropriate valuation methodology for a particular transaction, based on the risk in the transaction and loan portfolio (For example, higher-risk transactions or nonhomogeneous property types should be supported by more-thorough valuations. The financial institution should also set criteria for determining the extent to which an inspection of the collateral is necessary.)
- ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation
- implement policies and controls to preclude "value shopping" (Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property, the financial institution should adhere to a policy for selecting the most reliable method, rather than the highest value.)
- require sufficient documentation to support the collateral valuation in the appraisal or evaluation

AVMs

When AVMs are used to support evaluations or appraisals, the financial institution should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. This validation work should be in conformance with SR-11-7. In particular, the financial institution should document the validation's analysis, assumptions, and conclusions. The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a "confidence score," which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Financial institutions that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Institutions should also establish the confidence levels that are appropri-

21. In addition, a financial institution that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the financial institution can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under ECOA, and for reporting responsibilities under HMDA.

22. 12 CFR 208, subpart E, and 12 CFR 225, subpart G.

23. See SR-10-16, December 2, 2010, and its attachment.

ate for the risk in a given transaction or group of transactions.

When tax-assessment valuations are used as a basis for the collateral valuation, the financial institution should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value as part of the validation process.

Account Management

Since HELOCs often have long-term, interest-only payment features, financial institutions should have risk-management techniques that identify higher-risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, a financial institution should have risk-management procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account-management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account-management practices for large portfolios or portfolios with high-risk characteristics include—

- periodically refreshing credit-risk scores on all customers;
- using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
- periodically assessing utilization rates;
- periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;
- monitoring home values by geographic area; and
- obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Financial institutions should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.[24]

When appropriate, financial institutions should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circumstances.[25] In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances and (2) as a result of this change, the financial institution must have a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account-management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A financial institution's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

Portfolio Management

Financial institutions should implement an effective portfolio credit-risk management process for their home equity portfolios that includes the following.

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24. Under the Federal Reserve's risk-based capital guidelines, an unused HELOC commitment with an original maturity of one year or more may be allocated a zero percent conversion factor if the institution conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See 12 CFR 208, appendix A, III.D.4.

25. Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 CFR 226.5b(f)(3)(vi)(A)–(F).

Policies. The Federal Reserve's real estate lending standards regulations require that a financial institution's real estate lending policies be consistent with safe and sound banking practices and that the financial institution's board of directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the financial institution's overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

Portfolio objectives and risk diversification. Effective portfolio management should clearly communicate portfolio objectives such as growth targets, utilization, rate-of-return hurdles, and default and loss expectations. For financial institutions with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher-risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the financial institution should analyze the situation sufficiently to enable the financial institution's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, a financial institution should analyze the portfolio by segment, using criteria such as product type, credit-risk score, DTI, LTV, property type, geographic area, collateral-valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

Management information systems. By maintaining adequate credit MIS, a financial institution can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations. Financial institutions should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For institutions with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

- production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type
- delinquency and loss-distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI)
- vintage tracking
- the performance of third-party originators (brokers and correspondents)
- market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values

Policy- and underwriting-exception systems. Financial institutions should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

High-LTV monitoring. To clarify the real estate lending standards regulations and interagency guidelines, the agencies issued Guidance on High Loan-To-Value LTV Residential Real Estate Lending (the HLTV guidance) in October 1999. The HLTV guidance clarified the Interagency Real Estate Lending Guidelines and the supervisory loan-to-value limits for loans on one- to four-family residential properties. Financial institutions are expected to ensure compliance with the supervisory loan-to-value limits of the Interagency Real Estate Lending Guidelines. The HLTV guidance places emphasis on certain controls that financial institutions should have in place when engaging in HLTV lending. Financial institutions should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the financial institution's board of directors. Specifically, financial institutions are reminded that:

- Loans in excess of the supervisory LTV limits should be identified in the financial institution's records. The aggregate of high-LTV one- to four-family residential loans should not exceed 100 percent of the financial institution's total capital.[26] Within that limit, high-LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.
- In calculating the LTV and determining compliance with the supervisory LTVs, the financial institution should consider all senior liens. All loans secured by the property and held by the financial institution are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property equals or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.
- For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the financial institution is legally committed to lend over the life of the loan).
- All real estate secured loans in excess of supervisory LTV limits should be aggregated and included in a quarterly report for the financial institution's board of directors.

Certain insurance products have been developed to help financial institutions mitigate the credit risks of HLTV residential loans. Insurance policies that cover a "pool" of loans can be an efficient and effective credit-risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The Federal Reserve will consider pool insurance to be a sufficient credit enhancement to remove the HLTV designation in the following circumstances: (1) the policy is issued by an acceptable mortgage insurance company, (2) it reduces the LTV for each loan to less than 90 percent, and (3) it is effective over the life of each loan in the pool.

Stress testing for portfolios. Financial institutions with home equity concentrations as well as higher-risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Institutions should consider stress tests that incorporate interest-rate increases and declines in home values. Since these events often occur simultaneously, the testing should be performed for these events together. Institutions should also periodically analyze markets in key geographic areas, including identified "soft" markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

Operations, Servicing, and Collections

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit-risk management should oversee these support functions to ensure that operational risks are properly controlled.

Lien recording. Financial institutions should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

Problem-loan workouts and loss-mitigation strategies. Financial institutions should have established policies and procedures for problem-

26. For purposes of the Interagency Real Estate Lending Standards Guidelines, high-LTV one- to four-family residential property loans include (1) a loan for raw land zoned for one- to four-family residential use with an LTV ratio greater than 65 percent; (2) a residential land development loan or improved lot loan with an LTV greater than 75 percent; (3) a residential construction loan with an LTV ratio greater than 85 percent; (4) a loan on non-owner occupied one- to four-family residential property with an LTV greater than 85 percent; and (5) a permanent mortgage or home equity loan on an owner-occupied residential property with an LTV equal to or exceeding 90 percent without mortgage insurance, readily marketable collateral, or other acceptable collateral.

loan workouts and loss-mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's Uniform Retail Credit Classification and Account Management Policy, issued June 2000 (see SR-00-8 and the appendix to section 2130.1) and should, at a minimum, address the following:

- circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes (Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms.)
- circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure
- appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of workout loans (For large portfolios, vintage delinquency and loss tracking also should be included.)

While financial institutions are encouraged to work with borrowers on a case-by-case basis, a financial institution should *not* use workout strategies to defer losses. Financial institutions should ensure that credits in workout programs are evaluated separately for the allowance for loan and lease losses (ALLL), because such credits tend to have higher loss rates than other portfolio segments.

Secondary-Market Activities

More financial institutions are issuing HELOC mortgage-backed securities (i.e., securitizing HELOCs). Although such secondary-market activities can enhance credit availability and a financial institution's profitability, they also pose certain risk-management challenges. An institution's risk-management systems should address the risks of HELOC securitizations.[27]

27. See SR-02,16, "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," (see also section 3020.1) and the risk management and capital adequacy of exposures arising from secondary-market credit activities discussion in SR-97-21.

Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital

The FFIEC's Uniform Retail Credit Classification and Account Management Policy governs the classification of consumer loans and establishes general classification thresholds that are based on delinquency. Financial institutions and the Federal Reserve's examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Financial institutions should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, a financial institution should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for its HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher-risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.[28]

ALLOWANCE FOR LOAN AND LEASE LOSSES

A bank bases the adequacy of its allowance for loan and lease losses (ALLL), including amounts resulting from an analysis of the real estate portfolio, on a careful, well-documented, and consistently applied analysis of its loan and lease portfolio.[29] Guidance related to the ALLL is primarily addressed in section 2070.1. The

28. Section 2133.1 incorporates the January 2001 Interagency Expanded Guidance for Subprime Lending Programs. That guidance sets forth the supervisory expectations regarding risk-management processes, the ALLL, and capital adequacy for institutions engaging in subprime-lending programs.

29. The estimation process described in this section permits a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

following discussion summarizes general principles for assessing the adequacy of the ALLL.

Examiners should evaluate the methodology, documentation, and process that management has followed in arriving at an overall estimate of the ALLL to ensure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the examiner should review the reasonableness of management's overall estimate of the ALLL, as well as the range of possible credit losses, by taking into account these factors. The examiner's analysis should also consider the quality of the bank's systems and management's ability to identify, monitor, and address asset-quality problems.

As discussed in the earlier subsection on classification guidelines, examiners should consider the value of the collateral when reviewing and classifying a loan. For a performing commercial real estate loan, however, the supervisory policy does not require automatic increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important that the examiner recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan-administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise because of the wide range of factors that must be considered. Furthermore, the ability to estimate anticipated losses on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. The examiner should give considerable weight to management's estimates in assessing the adequacy of the ALLL when management has (1) maintained effective systems and controls for identifying, monitoring, and addressing asset-quality problems and (2) analyzed all significant factors affecting the collectibility of the portfolio.

REGULATORY COMPLIANCE

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

Transactions with affiliates. All transactions with affiliates should be on terms and conditions that are consistent with safe and sound banking practices. The bank is expected to comply with the limits and collateral requirements of sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and Regulation W (12 CFR 223).

Tie-in provisions. Section 106 of the Bank Holding Company Act Amendments of 1970 states that a bank is prohibited from fixing or varying the consideration for extending credit, leasing or selling property of any kind, or furnishing any product or service on the condition or requirement that a customer—

- obtain additional credit, property, or service from the bank, other than a loan, discount, deposit, or trust service (a "traditional bank product");
- obtain additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
- provide additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
- provide additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
- not obtain other credit, property, or service from the competitors of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

See the statutory exceptions in section 106(b) of the Bank Holding Company Act Amendments and the exceptions in the Federal Reserve's Regulation Y (12 CFR 225.7).

Insider lending activities. Loans to insiders should not contain more-favorable terms than those afforded to other borrowers nor should these loans pose a more-than-normal risk of repayment. The bank is expected to maintain adequate loan documentation of insider loans showing that proper approval for the loan was obtained. Such loans should comply with the Federal Reserve's Regulation O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks (12 CFR 215, subpart A).

Loans to executives, officers, directors, and principal shareholders of correspondent banks. There should be no preferential treatment on loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The bank should comply with title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)). (See also 12 CFR 215, subpart B.)

Appraisals and evaluations. Banks should obtain an appraisal or evaluation for all real estate-related financial transactions before making the final credit decision in conformance with title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC 3310, 3331–3351) and the Federal Reserve's Regulation H, Mem-bership of State Banking Institutions in the Federal Reserve System (12 CFR 208), as set forth in subpart G of Regulation Y (12 CFR 225). The Federal Reserve's appraisal and evaluation requirements are separately discussed in section 4140.1, "Real Estate Appraisals and Evaluations."

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

1. To determine if policies, practices, procedures, and internal controls for real estate loans are adequate to identify and manage the risks the bank is exposed to.
2. To ascertain if the institution has implemented risk-management programs that identify, measure, monitor, and control the inherent risks involved in real estate lending.
3. To determine if bank officers and staff are operating in conformance with the bank's established guidelines.
4. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
5. With respect to residential mortgage servicing, to review risk-management practices and controls in connection with a decision not to complete foreclosure proceedings after they have been initiated.
6. To determine compliance with applicable laws and regulations.
7. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

Home Equity Lending

1. To determine if the financial institution has an appropriate review and approval process for new product offerings, product changes, and marketing initiatives.
2. To ascertain whether the financial institution has appropriate control procedures for third parties that generate loans on its behalf and if the control procedures comply with the laws and regulations that are applicable to the organization.
3. To determine if the financial institution has given full recognition to the risks embedded in its home equity lending.
4. To determine whether the financial institution's risk-management practices have kept pace with the growth and changing risk profile of its home equity portfolios and whether underwriting standards have eased.
5. To determine whether the financial institution's loan policy—
   a. ensures prudent underwriting standards for home equity lending, including standards to ensure that a thorough evaluation of a borrower's capacity to service the debt is conducted (that is, the institution is not relying solely on the borrower's credit score);
   b. provides risk-management safeguards for potential declines in home values;
   c. ensures that the standards for interest-only and variable-rate home equity lines of credit (HELOCs) include an assessment of a borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates; and
   d. provides appropriate collateral-valuation policies and procedures and provides for the use and validation of automated valuation models.

1. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal or external auditors.
2. Review the board of directors minutes to ensure that real estate loan policies are reviewed and approved at least annually.
3. Test real estate loans for compliance with policies, practices, and procedures by performing the remaining examination procedures in this section. Obtain a listing of any deficiencies noted in the latest internal or external audit report, and determine if appropriate corrections have been made. Additionally, obtain a list of personnel changes. Determine if these changes are significant enough to influence the scope of the examination.
4. Obtain a trial balance and delinquency listing for all real estate loans.
   a. Reconcile the real estate department's trial balance totals to the bank's general ledger accounts.
   b. Review reconciling items for reasonableness.
   c. Obtain information (for example, paid-to dates, last date paid, and date of nonaccrual status) on past-due loans and loans on nonaccrual status.
5. Evaluate the bank with respect to—
   a. the adequacy of written policies and procedures relating to real estate loans;
   b. the operating compliance with established bank policy;
   c. favorable or adverse trends in the overall real estate lending activity;
   d. the accuracy and completeness of the bank's records;
   e. the adequacy of internal controls;
   f. adherence to lending policies, procedures, and authority by all appropriate personnel;
   g. compliance with laws, regulations, and Federal Reserve policy on real estate lending activity, including lending limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and lending practices;
   h. compliance with the Interagency Guidelines for Real Estate Lending Policies, including whether the bank is adequately documenting exceptions to supervisory loan-to-value (LTV) limits, whether the volume of nonconforming loans exceeds the capital limitations, and whether risk-management programs have been established and maintained to identify, measure, monitor, and control the inherent risks associated with high-LTV lending;
   i. compliance with the Interagency Credit-Risk Management Guidance for Home Equity Lending; and
   j. other matters of significance, including mortgage servicing, warehousing operations, and the loan-origination/resale process.
6. Select loans for examination, using an appropriate sampling technique drawn from judgmental (cutoff-amount approach) or statistical sampling. Analyze the performance of the loans selected for review by transcribing the appropriate information from the following list onto the real estate loan line cards, when applicable:
   a. collateral records and credit files
   b. loan agreements relative to any purchases, transfers, participations, or sales that have been entered into since the last examination
   c. loan commitments and other contingent liabilities
   d. loan-modification agreements or restructuring terms to identify a reduction in interest rate or principal payments, deferral of interest or principal payments, or other restructurings of terms
   e. past-due/nonaccrual-related information
   f. loan-specific internal information from problem credit analyses
   g. escrow-analysis reports, including the status of property tax payments and escrow advances by the bank to cover delinquent property taxes
   h. the status of mortgage insurance claims either for government insurance or guarantee programs or for private mortgage insurance, including procedures for ensuring coverage and reporting procedures for filing claims and contested claims, if any

   i. loans to insiders and their interests
7. In analyzing the selected real estate loans, consider the following procedures, taking appropriate action if necessary:
   a. Determine the primary source of repayment and evaluate its adequacy.
   b. Assess the quality of any secondary collateral afforded by the loan guarantors or partners.
   c. Compare collateral values with outstanding debt. Determine whether the loan's LTV ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.
   d. Assess the adequacy of the appraisal or evaluation.
   e. Ascertain whether the loan complies with established bank policy.
   f. Identify any deficiencies in the loan's documentation in the credit files, the collateral records, or both.
   g. Has the bank decided not to complete any foreclosures after the foreclosure process was initiated? If yes, continue with these examination procedures.
      1) Review the bank's policies and procedures for regular monitoring of property values to support the analysis to continue or abandon the foreclosure. Collateral valuation information should be sufficient to support a decision to initiate, continue, or abandon a foreclosure proceeding. Refer to the *Interagency Appraisal and Evaluation Guidelines* in section 4140.1 or see SR-10-16.
      2) Discuss findings with the organization's management and obtain any necessary commitment for corrective action. Assess whether these actions will address the noted deficiencies and weaknesses and, if not, determine whether supervisory action is necessary.
   h. Identify whether the loan is to an officer, a director, or a shareholder of the bank or to a correspondent bank. Determine whether an officer, a director, or a shareholder of the bank is a guarantor on the loan.
   i. Review the borrower's compliance with provisions of the loan agreement. Review the borrower's payment performance, indicating whether the loan is past due.
   j. Determine if there are any problems that may jeopardize the repayment of the real estate loan.
   k. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank, from a participation or sale with another institution, or from the repossession of the property.
   l. Identify whether the loan is to a firm or to individuals who are principals of a firm that provided professional services to the bank, including attorneys, accountants, and appraisers. If so, determine if the loan has received preferential treatment.
8. For loan participations, either in whole or in part, to or with another lending institution, review, if applicable—
   a. participation certificates and agreements, on a test basis, to determine if the contractual terms are being adhered to;
   b. loan documentation to see if it meets the bank's underwriting procedures (that is, the documentation for loan participations should meet the same standards as the documentation for loans the bank originates);
   c. the transfer of loans immediately before the date of the examination to determine if the loan was either nonperforming or classified and if the transfer was made to avoid possible criticism during the current examination; and
   d. losses to determine if such losses are shared on a pro rata basis.
9. For participations between an institution that has a different primary regulator and loans in the Shared National Credit program—
   a. identify loans to be included in the Shared National Credit review;
   b. inform the Reserve Bank of any classified participation loans that were not covered by the Shared National Credit program and in which the participant(s) had a different primary regulator; and
   c. inform the Reserve Bank of those loans eligible for the Shared National Credit program that were not previously reviewed.
10. In connection with the examination of other lending activity in the bank—

a. check the central liability file on the borrower(s) and determine whether the total indebtedness of the borrower exceeds the lending limit to a single borrower; and
b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non–real estate loans, leasing, overdrafts, and cash items). Determine the total indebtedness of these borrowers to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.

11. Consult with the examiner responsible for the asset-liability management analysis portion of the examination to determine the appropriate maturity breakdown of real estate loans needed for the analysis. Prepare the necessary schedules.
12. Summarize the findings of the real estate loan portfolio review and address the following:
    a. the scope of the examination
    b. the quality of the policies, procedures, and controls
    c. the general level of adherence to policies and procedures
    d. the competency of management and loan officers, including the identification of individuals with an excessively high level of problem loans or documentation exceptions
    e. the quality of the loan portfolio
    f. loans not supported by current and complete financial information
    g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, title policy, proof of insurance, deeds of trust, and mortgage notes
    h. loans to officers, directors, shareholders, or their interests
    i. causes of existing problems
    j. delinquent loans
    k. concentrations of credits
    l. classified loans
    m. violations of laws, regulations, and Federal Reserve policy
    n. action taken by management to correct previously noted deficiencies, and corrective actions recommended to management at this examination, with the bank's response to them

Home Equity Lending

1. Review the credit policies for home equity lending to determine if the underwriting standards address all relevant risk factors (that is, an analysis of a borrower's income and debt levels, credit score, and credit history versus the loan's size, the collateral value (including valuation methodology), the lien position, and the property type and location).
2. Determine whether the financial institution's underwriting standards include—
    a. a properly documented evaluation of the borrower's financial capacity to adequately service the debt;
    b. an adequately documented evaluation of the borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates for interest-only and variable-rate home equity lines of credit (HELOCs).
3. Assess the reasonableness and adequacy of the analyses and methodologies underlying the financial institution's evaluation of borrowers.
4. If the financial institution uses third parties to originate home equity loans, find out—
    a. if the institution delegates the underwriting function to a broker or correspondent;
    b. if the institution's internal controls for delegated underwriting are adequate;
    c. whether the institution retains appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function;
    d. if there are adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the institution's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations;
    e. if the institution has a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the quality of

loans that the third party underwrites; and
f. whether the institution has adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to Real Estate Settlement Procedures Act (RESPA) prohibitions.

5. Evaluate the adequacy of the financial institution's collateral-valuation policies and procedures. Ascertain whether the institution—
   a. establishes criteria for determining the appropriate valuation methodology for a particular transaction (based on the risk in the transaction and loan portfolio);
   b. sets criteria for determining when a physical inspection of the collateral is necessary;
   c. ensures that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation;
   d. implements policies and controls to preclude "value shopping"; and
   e. requires sufficient documentation to support the collateral valuation in the appraisal or evaluation.
6. If the financial institution uses automated valuation models (AVMs) to support evaluations or appraisals, find out if the institution—
   a. implements policies and controls to preclude "value shopping" in its use of AVMs;
   b. periodically validates the models, to mitigate the potential valuation uncertainty in the model;
   c. adequately documents the validation's analysis, assumptions, and conclusions;
   d. back-tests a representative sample of evaluations and appraisals supporting loans outstanding; and
   e. evaluates the reasonableness and adequacy of its procedures for validating AVMs.
7. If tax-assessment valuations are used as a basis for collateral valuation, ascertain whether the financial institution is able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value, as part of the validation process.
8. Review the risk- and account-management procedures. Verify that the procedures are appropriate for the size of the financial institution's loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the institution.
9. If the financial institution has large home equity loan portfolios or portfolios with high-risk characteristics, determine if the institution—
   a. periodically refreshes credit-risk scores on all customers;
   b. uses behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
   c. periodically assesses utilization rates;
   d. periodically assesses payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current;
   e. monitors home values by geographic area; and
   f. obtains updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

   Determine if the frequency of the above actions is commensurate with the risk in the portfolio.
10. Verify that annual credit reviews of HELOC accounts are conducted. Verify if the reviews of HELOC accounts determine whether the line of credit should be continued, based on the borrower's current financial condition.
11. Determine that authorizations of over-limit home equity lines of credit are restricted and subject to appropriate policies and controls.
    a. Verify that the financial institution requires over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits.
    b. Evaluate the sufficiency of management information systems (MIS) that enable management to identify, measure, monitor, and control the risks associated with over-limit accounts.
12. Verify that the financial institution's real estate lending policies are consistent with safe and sound banking practices and that its board of directors reviews and approves the policies at least annually.
13. Determine whether the MIS—

a. allows for the segmentation of the loan portfolios;
b. accurately assesses key risk characteristics; and
c. provides management with sufficient information to identify, monitor, measure, and control home equity concentrations.

14. Determine whether management periodically assesses the adequacy of its MIS, in light of growth and changes in the financial institution's risk appetite.
15. If the financial institution has significant concentrations of HELs or HELOCs, determine if the MIS includes, at a minimum, reports and analysis of the following:
    a. production and portfolio trends by product, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type
    b. the delinquency and loss-distribution trends by product and originator channel, with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI)
    c. vintage tracking
    d. the performance of third-party originators (brokers and correspondents)
    e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values.
16. Determine whether the financial institution accurately tracks the volume of high-LTV (HLTV) loans, including HLTV home equity and residential mortgages, and if the financial institution reports the aggregate of these loans to its board of directors.
17. Determine whether loans in excess of the supervisory LTV limits are identified as high-LTV loans in the financial institution's records. Determine whether the institution reports, on a quarterly basis, the dollar value of such loans to its board of directors.
18. Find out whether the financial institution has purchased insurance products to help mitigate the credit risks of its HLTV residential loans. If a policy has a coverage limit, determine whether the coverage may be exhausted before all loans in the pool mature or pay off.
19. Determine whether the financial institution's credit risk-management function oversees the support function(s). Evaluate the effectiveness of controls and procedures over staff who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes.
20. Determine whether policies and procedures have been established for home equity problem-loan workouts and loss-mitigation strategies.
21. Summarize the findings of the home equity loan portfolio review.

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. 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.

LOAN POLICIES

1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written real estate loan policies that define—
   a. the institution's target market?
   b. loan portfolio diversification standards?
   c. acceptable collateral types?
   d. prudent, clear, and measurable underwriting standards, including relevant credit factors such as—
      - maximum loan amount by type of property?
      - maximum loan maturity by type of property?
      - repayment terms?
      - pricing structure for each type of real estate loan?
      - loan-to-value (LTV) limits by type of property?
   e. procedures for reviewing real estate loan applications?
   f. loan-origination and -approval procedures (including loan-authority limits) by size and type of loan?
   g. review and approval procedures for exception loans?
   h. loan-administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
   i. minimum loan-documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
   j. LTV limits that are consistent with regulatory supervisory limits?
   k. real estate appraisal and evaluation programs consistent with the Federal Reserve's appraisal regulation (12 CFR 208.50–51), the Interagency Appraisal and Evaluation Guidelines (see section 4140.1), and the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions (see SR-03-18)?
   l. reporting requirements to the board of directors relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are real estate policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?

LOAN RECORDS

*1. Are the preparation and posting of subsidiary real estate loan records performed or adequately reviewed by persons who do not also—
   a. issue official checks and drafts?
   b. handle cash receipts?
   c. reconcile subsidiary records to general ledger controls?

*2. Are the subsidiary real estate loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

3. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors, along with the experience of the high-LTV loan portfolio?

4. Are loan statements, delinquent-account-collection requests, and past-due notices reconciled to the real estate loan subsidiary records? Are the notices and reconcili-

ations handled by persons who do not also handle cash?
5. Are inquiries about loan balances received and investigated by persons who do not also handle cash?
*6. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
7. Does the bank maintain a daily record summarizing note-transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
8. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?
9. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
10. Are past-due-loan reports generated daily?

LOAN INTEREST AND COMMITMENT FEES

*1. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
2. Are any independent interest and fee computations made and compared with or adequately tested to loan interest records by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

PROCESSING AND DOCUMENT CONTROL

*1. Are all real estate loan commitments issued in written form?
2. Are loan officers prohibited from processing loan payments?
*3. Are loan payments received by mail recorded upon receipt independently before being sent to and processed by a note teller?
*4. Regarding mortgage documents—
   a. Has the responsibility for the document files been established?
   b. Does the bank use a check sheet to ensure that required documents are received and on file?
   c. Are safeguards in effect to protect notes and other documents?
   d. Does the bank obtain a signed application form for all real estate mortgage loan requests?
   e. Are separate credit files maintained?
   f. Is there a program of systematic follow-up to determine that all required documents are received after the loan closing and from public recording offices?
   g. Does a designated employee conduct a review after loan closing to determine if all documents are properly drawn, executed, recorded, and filed within the loan files?
   h. Are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, canceled, and marked paid, where appropriate?
   i. Are charged-off notes and related files segregated and adequately controlled?

LOAN ORIGINATION

1. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?
2. Does the bank have a mortgage errors and omission policy?
3. Are procedures in effect to ensure compliance with the requirements of governmental agencies that insure or guarantee loans or with the requirements of private mortgage insurance companies?

ESCROW PROCESSING

1. Regarding insurance and property taxes coverage—
   a. Is there a procedure for determining that private mortgage insurance premiums are current on insured loans?
   b. Is there a procedure for determining that property and hazard insurance premiums are current on properties securing loans?

c. Does the bank require that the hazard insurance policies include a loss-payable clause to the bank?
d. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?
e. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
f. If advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

LOAN ADMINISTRATION

*1. Are approvals of real estate advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?
2. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

COLLECTIONS AND FORECLOSURES

1. Does the bank have adequate collection procedures to monitor delinquencies and, as necessary, have procedures to pursue foreclosure?
2. Are properties under foreclosure proceedings segregated?
   a. Has the bank decided not to complete any foreclosures after the foreclosure process was initiated? If yes,
      1) Are there policies and procedures for regularly monitoring the property values to support the analysis—to continue or abandon the foreclosure? Is the collateral valuation information sufficient to support a decision to initiate, continue, or abandon a foreclosure proceeding?
      2) After discussing the examination findings with the organization's management, were the necessary commitments obtained for corrective action? Will these actions address the noted deficiencies and weaknesses? If not, is supervisory action is necessary?
3. Are properties to which the bank has obtained title appropriately transferred to other real estate owned (OREO)? See "Other Real Estate Owned," section 2200.1, for requirements.
4. Does the bank have an adequate management and sales disposition program for timely liquidation of OREO? Does the program take into account the maximum retention period for OREO allowed under state law?
5. Does the bank have adequate procedures for filing and monitoring its mortgage insurance claims for government-insured or -secured programs and for private mortgage insurance?

HOME EQUITY LENDING

Policies

1. Do the credit policies for home equity lending address the underwriting standards for all relevant risk factors, such as—
   a. an analysis of a borrower's income and debt levels?
   b. an analysis of a borrower's credit score and credit history versus the loan's size?
   c, the collateral value (including valuation methodology)?
   d. the lien position?
   e. the property type and location?
2. Are the financial institution's risk-and account-management procedures appropriate for the size of the institution's loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the institution?
3. Does the financial institution have reasonable and adequate policies and procedures for home equity problem-loan workouts and loss-mitigation strategies?

Underwriting

4. Has the financial institution purchased insurance products to mitigate the credit risks of its high-LTV (HLTV) residential loans?

   a. If so, do any of those insurance policies have a coverage limit?
   b. Has the institution conducted reasonable and adequate analyses to determine whether the coverage may be exhausted before all loans in the pool covered by the insurance product mature or pay off?
5. Does the financial institution's credit-risk management function oversee the support function(s) for its real estate lending? Does the institution have effective controls and procedures over staff who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes?
6. Do the financial institution's underwriting standards include—
   a. a properly documented evaluation of the borrower's financial capacity to adequately service the debt?
   b. an adequately documented evaluation of the borrower's ability to—
      - amortize the fully drawn line of credit over the loan term?
      - absorb potential increases in interest rates for interest-only and variable-rate home equity lines of credit (HELOCs)?
7. Are the analyses and methodologies underlying the institution's evaluation of borrowers reasonable and adequate?
8. Does the financial institution use third parties to originate home equity loans? If so, does the institution—
   a. delegate the underwriting function to a broker or correspondent?
   b. have adequate internal controls for its delegated underwriting?
   c. retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function?
   d. have adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the institution's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations?
   e. have a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the quality of loans that the third party underwrites?
   f. have adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications and are not otherwise receiving referral or unearned income or fees contrary to Real Estate Settlement Procedures Act (RESPA) prohibitions?

Collateral Valuation

9. Does the financial institution have adequate collateral-valuation policies and procedures that—
   a. establish criteria for determining the appropriate valuation methodology for a particular transaction (based on the risk in the transaction and loan portfolio)?
   b. set criteria for determining when a physical inspection of the collateral is necessary?
   c. ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation?
   d implement controls to preclude "value shopping?"
   e. require sufficient documentation to support the collateral valuation in the appraisal or evaluation?
10. Does the financial institution use automated valuation models (AVMs) to support evaluations or appraisals? If so, does the institution—
   a. periodically validate the models, to mitigate the potential valuation uncertainty in the model?
   b. adequately document the validation's analysis, assumptions, and conclusions?
   c. implement controls to preclude "value shopping" in its use of AVMs?
   d. back-test a representative sample of evaluations and appraisals supporting loans outstanding?
   e. evaluate the reasonableness and adequacy of its procedures for validating AVMs?

11. Are tax-assessment valuations used as a basis for collateral valuation? If so, is the financial institution able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value, as part of the validation process?

Risk Concentrations

12. Does the financial institution have large home equity loan portfolios or portfolios with high-risk characteristics? If so, does the institution—
    a. periodically refresh credit-risk scores on all customers?
    b. use behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts?
    c. periodically assess utilization rates?
    d. periodically assess payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current?
    e. monitor home values by geographic area?
    f. obtain updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral?

    Are the frequency of these actions commensurate with the risk in the portfolio?

Management Information Systems

13. Are the financial institution's real estate lending policies consistent with safe and sound banking practices, and does its board of directors review and approve the policies at least annually?
14. Do the financial institution's management information systems (MIS) for real estate lending—
    a. allow for the segmentation of the loan portfolios?
    b. accurately assess key risk characteristics?
    c. provide management with sufficient information to identify, monitor, measure, and control home equity concentrations?
15. Does the financial institution's management periodically assess the adequacy of its MIS, in light of growth and changes in the institution's risk appetite?
16. Does the financial institution have significant concentrations of HELs or HELOCs? If so, does the MIS include, at a minimum, reports and analysis of—
    a. production and portfolio trends by product, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type?
    b. the delinquency and loss-distribution trends, by product and originator channel, with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, or DTI)?
    c. vintage tracking?
    d. the performance of third-party originators (brokers and correspondents)?
    e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values?
17. Do the financial institution's records identify loans in excess of the supervisory LTV limits as high-LTV (HLTV) loans? Is the aggregate dollar value of such loans reported quarterly to the instution's board of directors? Does the volume of HLTV loans exceed 100 percent of the institution's capital?

Internal Loan Review

18. Does the financial institution conduct annual credit reviews of HELOC accounts? Does the review of HELOC accounts determine whether the line of credit should be continued, based on the borrower's current financial condition?
19. Are the financial institution's authorizations of over-limit home equity lines of credit restricted? Are they subject to appropriate policies and controls?
    a. Does the institution require over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits?

b. Is MIS sufficient to enable management to identify, measure, monitor, and control the risks associated with over-limit accounts?

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. On the basis of a composite evaluation, are internal controls adequate, as evidenced by answers to the foregoing questions?

A construction loan is used to finance the construction of a particular project within a specified period of time and is funded by supervised disbursements of a predetermined amount over the construction period. When properly controlled, a bank can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame. However, the higher rate of return demanded by construction lenders is indicative of the higher risks assumed.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent on whether the borrower either obtains permanent financing or finds a buyer with sufficient funds to purchase the completed project. Because many borrowers anticipate retaining ownership after construction, the cost and availability of funds from permanent financing is a primary factor to be considered by the bank in assessing the risk of a construction loan.

A construction loan is generally secured by a first mortgage or deed of trust on the land and improvements, which is often backed by a purchase agreement from a financially sound investor or by a takeout financing agreement from a responsible permanent lender. A long-term mortgage loan (permanent financing) is typically obtained before or simultaneously with the construction loan and is made to refinance the short-term construction loan. Additionally, the bank may require a borrower to provide secondary collateral in the form of a junior interest in another real estate project or a personal guarantee.

BANK LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of bank involvement. The bank's lending policies should reflect prudent lending standards and set forth pricing guidelines, limits on loan-to-value ratios and debt-coverage ratios, and yield requirements. Such policies should also address procedures relative to controlling disbursements in a manner that is commensurate with the progress of construction.

Lending Limits

A bank should have established and well-controlled construction lending limits that are within the acceptable standards of state banking regulations. State banking statutes governing construction lending may contain minimum standards of prudence without specifying actual loan terms.

The bank's internal limits should not exceed the supervisory loan-to-value (LTV) limits set forth in the Interagency Guidelines for Real Estate Lending Policies, as required by the Federal Deposit Insurance Corporation Improvement Act of 1991 (12 USC 1828(c)) and included as appendix C of the Federal Reserve's Regulation H. These guidelines and the accompanying LTV limits are discussed in "Real Estate Loans," section 2090.1. Generally, the LTV ratio should not exceed the following supervisory limits:

- 65 percent for raw-land loans
- 75 percent for land-development and improved-land loans
- 80 percent for commercial, multifamily, and other nonresidential construction loans
- 85 percent for one- to four-family residential construction loans

For loans that fund multiple phases of the same real estate project, the appropriate LTV limit is the supervisory LTV limit applicable to the final phase of the project.

Lending Risks

Construction loans are vulnerable to a wide variety of risks. Critical to the evaluation of any construction loan is the analysis of the project's feasibility study to ascertain the developer's risk, which affects the lender's risk. The major portion of the risk is attributable to the need to complete a project within specified cost and time limits. Examples of difficulties that may arise include—

- completion of a project after takeout dates, which voids permanent funding commitments;

- cost overruns, which may exceed takeout commitments or sale prices;
- the possibility that the completed project will be an economic failure;
- the diversion of progress payments, resulting in nonpayment of material bills or subcontractors;
- a financial collapse or the failure of the contractors, subcontractors, or suppliers to perform before the completion date;
- increased material or labor costs;
- the destruction of improvements from unexpected natural causes; and
- an improper or lax monitoring of funds advanced by the bank.

TYPES OF CONSTRUCTION LOANS

The basic types of construction lending are unsecured front-money, land-development, residential construction, and commercial construction loans. It is not uncommon for a bank to provide the acquisition, development, and construction loans for a particular project.

Unsecured Front-Money Loans

Front-money loans are considered very risky and should not be undertaken unless the bank has the expertise to evaluate the credit risk. These loans may represent working-capital advances to a borrower who may be engaged in a new and unproven venture. The funds may be used to acquire or develop a building site, eliminate title impediments, pay architect or standby fees, and meet minimum working-capital requirements established by construction lenders. Because repayment often comes from the first draw against construction financing, many construction loan agreements prohibit the use of the first advance to repay nonconstruction costs. Unsecured front-money loans used as a developer's equity investment in a project or to cover initial cost overruns are symptomatic of an undercapitalized or possibly an inexperienced or inept builder.

Land-Development Loans

Land-development or off-site-improvement loans are intended to be secured-purchase loans or unsecured advances to creditworthy borrowers. A development loan involves the purchase of land and lot development in anticipation of further construction or sale of the property. In addition to funding the acquisition of the land, a development loan may be used to fund the preparation of the land for future construction, including the grading of land, installation of utilities, and construction of streets.

Effective administration of a land-development loan begins with a plan defining each step of the development. The development plan should incorporate cost budgets, including legal expenses for building and zoning permits, environmental impact statements, costs of installing utilities, and all other projected costs of the development. Bank management's review of the plan and related cost breakdowns should provide the basis for determining the size, terms, and restrictions for the development loan. Refer to the subsection below on the assessment of real estate collateral for further discussion.

The LTV ratio should provide for sufficient margin to protect the bank from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the bank's collateral position or repayment prospects. If the loan involves the periodic development and sale of portions of the property under lien, each separately identifiable section of the project should be independently appraised, and any collateral should be released in a manner that maintains a reasonable margin. The repayment program should be structured to follow the sales or development program. Control over development loans can be best established when the bank finances both the development and the construction or sale phases of the project.

In the case of an unsecured land-development loan, it is essential to analyze the borrower's financial statements to determine the source of loan repayment. In establishing the repayment program, the bank should review sales projections to ensure that they are not overly optimistic. Additionally, banks should avoid granting loans to illiquid borrowers or guarantors who provide the primary support for a borrower (project).

Residential Construction Loans

Residential construction loans are made either on a speculative basis, where homes are built to be sold later in the general market, or for a specific buyer with prearranged permanent financing. Loans financing residential projects that do not have prearranged homebuyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. However, smaller banks are often engaged in this type of financing, and the aggregate total of individual speculative construction loans may equal a significant portion of their capital funds. It is important to ensure that the homebuyer has arranged permanent financing before the bank finances the construction; otherwise, the bank may find itself without a source of repayment. Construction loans without takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds 25 percent of the bank's capital structure (tier 1 capital plus loan loss reserves).

Proposals to finance speculative construction should be evaluated according to predetermined policies that are compatible with the institution's size, the technical competence of its management, and the housing needs of its service area. The prospective borrower's reputation, experience, and financial condition should also be reviewed to assess the likelihood of completing the proposed project. Until the project is completed, the actual value of the real estate is questionable. Thus, the marketability of the project should be substantiated in a feasibility study, reflecting a realistic assessment of current favorable and unfavorable local housing market conditions. As in any real estate loan, the bank must also obtain an appraisal or evaluation for the project. The appraisal or evaluation and the feasibility study are important tools to be used by lenders in evaluating project risks. For projects located out of area, the lender may lack market expertise, which makes evaluating the reasonableness of the marketing plan and feasibility study more difficult, and therefore makes the loan inherently riskier.

A bank dealing with speculative builders should have control procedures tailored to the individual project. A predetermined limit on the number of unsold units to be financed at any one time should be included in the loan agreement to avoid overextending the builder's capacity. The construction lender should receive current inspection reports indicating the project's progress. In some instances, the construction lender is also the permanent mortgagor. Loans on larger residential construction projects are usually negotiated with prearranged permanent financing as part of the construction loan.

Commercial Construction Loans

A bank's commercial construction lending activity can encompass a wide range of projects—apartments, condominiums, office buildings, shopping centers, and hotels—with each requiring a special set of skills and expertise to successfully manage, construct, and market.

Commercial construction loan agreements should normally require the borrower to have a precommitted extended-term loan to "take out" the construction lender. Takeout-financing agreements, however, are usually voidable if construction is not completed by the final funding date, if the project does not receive occupancy permits, or if the preleasing or occupancy rate does not meet an agreed-upon level. A bank can also enter into an open-end construction loan where there is no precommitted source to repay the construction loan. Such loans pose an added risk because the bank may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the bank should consider whether the completed project will be able to attract extended-term financing, supportable by the projected net operating income.

The risk of commercial construction requires a complete assessment of the real estate collateral, borrower's financial resources, source of the extended-term financing, and construction plans. As it does any real estate loan, the bank must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's appraisal regulation. Additionally, the borrower should provide a feasibility study for the project that details the project's marketing plan, as well as an analysis of the supply-and-demand factors affecting the projected absorption rate. For an open-end construction loan, the feasibility study is particularly important to the bank's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The bank also needs to assess the borrower's development expertise, that is, whether the borrower can complete the project within budget and according to the construction plans. The financial risk of the project is contingent on the borrower's development expertise because the source of the extended-term loan may be predicated upon a set date for project completion. Until the project is completed, the actual value of the real estate is questionable.

A bank may reduce its financial risk by funding the construction loan after the borrower has funded its share of the project equity (for example, by paying for the feasibility study and land-acquisition and -development costs). An alternative approach would require the borrower to inject its own funds into the project at agreed-upon intervals during the project's management, construction, and marketing phases to coincide with the construction lender's contributions. In larger projects, equity injections can be provided by equity partners or joint ventures. These can take the form of equity syndications,[1] whose contributions are injected in the project in phases. A bank should assess the likelihood of the syndication being able to raise the necessary equity.

BANK ASSESSMENT OF THE BORROWER

The term *borrower* can refer to different types of entities. These forms can range from an entity whose sole asset is the project being financed to an entity that has other assets available to support the debt in addition to the project being financed (a multi-asset entity).

Although the value of the real estate collateral is an important component of the loan approval process, the bank should not place undue reliance on the collateral value in lieu of an adequate analysis of the borrower's ability to repay the loan. The analytical factors differ depending on the purpose of the loan, such as residential construction versus the various types of commercial construction loans.

The bank's analysis is contained in its documentation files, which should include background information on the borrower and partner/guarantor concerning their character and credit history, expertise, and financial statements (preferably audited) for the most recent fiscal years. Background information regarding a borrower's and partner's/guarantor's character and credit history is based upon their work experience and previous repayment practices, both relative to trade creditors and financial institutions. The documentation files should indicate whether the borrower has demonstrated it can successfully complete the type of project to be undertaken. The financial statements should be analyzed to ensure that the loan can be repaid in the event that a takeout does not occur.

The degree of analysis depends on whether the borrower is in reality a single-asset entity or a multi-asset entity. A loan to a single-asset entity is often predicated upon the strength of the partners/guarantors. Accordingly, understanding their financial strength, which frequently is made up of various partnership interests, is key to assessing the project's strength. In this example, it would be necessary to obtain financial information on the partner's/guarantor's other projects, even those not financed by the bank, to understand their overall financial condition. This is necessary because other unsuccessful projects may cause financial trouble for the partner/guarantor, despite a successful sales program by the bank's borrower. Issues to be considered, in addition to those raised in the preceding paragraph, include the vacancy rates of the various projects, break-even points, and rent rolls.

A loan to a multi-asset entity has similar characteristics to those found in the single-asset entity, in that it is necessary to evaluate all of the assets contained therein to ascertain the actual financial strength. In both cases, assessment of the project under construction would include pre-leasing requirements. For a loan with a takeout commitment, the financial strength and reputation of the permanent lender should be analyzed. For a loan without a takeout commitment, or one in which the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. See the "Real Estate Loans" section in this manual, on the bank's assessment of the borrower, for additional factors to be considered.

In instances where approval for the loan is predicated upon the strength of entities other than the borrower (partner/guarantor), the bank should obtain information on their financial condition, income, liquidity, cash flow, contingent liabilities, and any other relevant factors that exist to demonstrate their financial capacity

1. *Syndication* generally refers to the act of bringing together a group of individuals or entities to invest in a real estate project and does not refer to any particular legal form of ownership. The legal form varies depending on the investors' investment objectives, division of tax benefits, responsibility for project management, and desire to limit personal liability. The investment vehicle may be a general partnership, limited partnership, joint venture, tenancy in common, corporation, real estate investment trust, or common law trust.

to fulfill the obligation in the event that the borrower defaults.

Partners/guarantors generally have investments in other projects included as assets on their financial statements. The value of these investments frequently represents the partner's/guarantor's own estimate of the investment's worth, as opposed to a value based upon the investment's financial statements. As a result, it is necessary to obtain detailed financial statements for each investment to understand the partner's/guarantor's complete financial picture and capacity to support the loan. The statements should include detailed current and accurate cash-flow information since cash flow is often the source of repayment.

It is also important to consider the number and amount of the guarantees currently extended by a partner/guarantor to determine if they have the financial capacity to fulfill the contingent claims that exist. Furthermore, the bank should review the prior performance of the partner/guarantor to voluntarily honor the guarantee as well as the marketability of the assets collateralizing the guarantee. Since the guarantee can be limited to development and construction phases of a project, the bank should closely monitor the project before issuing a release to the partner/guarantor.

BANK ASSESSMENT OF REAL ESTATE COLLATERAL

Banks should obtain an appraisal or evaluation, as appropriate, for all real estate–related financial transactions before making the final credit or other decision. See "Real Estate Appraisals and Evaluations," section 4140.1, for a description of the related requirements a bank must follow for real estate–related financial transactions. The appraisal section explains the standards for appraisals, indicates which transactions require an appraisal or an evaluation, states qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches.

The appraisal or evaluation techniques used to value a proposed construction project are essentially the same as those used for other types of real estate. The aggregate principal amount of the loan should be based on an appraisal or evaluation that provides, at a minimum, the "as is" market value of the property.[2] Additionally, the bank will normally request the appraiser to report the "as completed" value.[3] Projections should be accompanied by a feasibility study explaining the effect of projected property improvements on the market value of the land. The feasibility study may be a separate report or incorporated into the appraisal report. If the appraiser uses the feasibility study, the appraiser's acceptance or rejection of the study and its effect on the value should be fully explained in the appraisal. An institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions. The real estate lending functions include commercial real estate mortgage departments, capital-market groups, and asset-securitization and -sales units. Concerns about the independence of real estate appraisal and evaluation programs include the risk that improperly prepared appraisals and evaluations may undermine the integrity of credit-underwriting processes. More broadly, an institution's lending functions should not have undue influence that might compromise the program's independence. See the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions (SR-03-18).

Management is responsible for reviewing the reasonableness of the appraisal's or evaluation's assumptions and conclusions. Also, management's rationale in accepting and relying upon the appraisal or evaluation should be in writing and made a part of loan documentation. In assessing the underwriting risks, management should reconsider any assumptions used by an appraiser that reflect overly optimistic or pessimistic values. If management, after its review of the appraisal or evaluation, determines that there

2. The "as is" value is the value of the property in its current physical condition and subject to the zoning in effect as of the date of appraisal.

3. The "as completed" value reflects the value of the land and the projected improvements. A bank may also request a value based on stabilized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed development is not the market value of the development. For proposed residential developments that involve the sale of individual houses, units, or lots, the appraisal should reflect deductions and discounts for holding costs, marketing costs, and entrepreneurial profit. For proposed and rehabilitated income-producing properties, the appraisal should reflect appropriate deductions and discounts for leasing commissions, rent losses, and tenant improvements from the estimated value based on stabilized occupancy.

are unsubstantiated assumptions, the bank may request the appraiser or evaluator to provide a more detailed justification of the assumptions or a new appraisal or evaluation. The approval of the loan is based upon the value of the project after the construction is completed. Insofar as the value component of the loan-to-value ratio is concerned, it is important for the bank to closely monitor the project's progress (value) during the construction period. See "Real Estate Loans," section 2090.1, for additional information relative to the real estate collateral assessment.

LOAN DOCUMENTATION

The loan documentation should provide information on the essential details of the loan transaction, the security interest in the real estate collateral, and the takeout loan commitment, if any. The necessary documentation before the start of construction generally includes:

- Financial and background information on the borrower to substantiate the borrower's expertise and financial strength to complete the project.
- The construction loan agreement, which sets forth the rights and obligations of the lender and borrower, conditions for advancing funds, and events of default. In some states, the agreement must be cited in either the deed of trust or the mortgage.
- A recorded mortgage or deed of trust, which can be used to foreclose and obtain title to the collateral.
- A title insurance binder or policy, usually issued by a recognized title insurance company or, in some states, an attorney's opinion. The title should be updated with each advance of funds to provide additional collateral protection.
- Insurance policies and proof of payment as evidence that the builder has adequate and enforceable coverage for liability, fire and other hazards, and vandalism and malicious mischief losses.
- An appropriate appraisal or evaluation showing the value of the land and improvements to date or, possibly, a master appraisal based on specifications for a multiphase development.
- Project plans, a feasibility study, and a construction budget showing the development plans, project costs, marketing plans, and equity contributions. A detailed cost breakdown of land, "hard" construction costs, and indirect or "soft" construction costs (such as construction loan interest; organizational and administration costs; and architectural, engineering, and legal fees) should be included.
- Property surveys, easements, an environmental impact report, and soil reports that indicate construction is feasible on the selected development site. The bank should also obtain the architect's certification of the plan's compliance with all applicable building codes and zoning, environmental protection, and other government regulations, as well as the engineer's report on compliance with building codes and standards. If internal expertise is not available, a bank may need to retain an independent construction expert to review these documents to assess the reasonableness and appropriateness of the construction plans and costs.
- The takeout commitment from the permanent lender, if applicable, and the terms of the loan. The bank should verify the financial strength of the permanent lender to fund the takeout commitment.
- A completion or performance bond signed by the borrower that guarantees the borrower will apply the loan proceeds to the project being financed.
- An owners' affidavit or a borrowing resolution empowering the borrower or its representative to enter into the loan agreement.
- Evidence that property taxes have been paid to date.

These documents furnish evidence that the lending officer is obtaining the information necessary for processing and servicing the loan and protect the bank in the event of default.

Documentation for Residential Construction Loans on Subdivisions

The documents mentioned above are usually available for residential construction loans on subdivisions (tracts). Documentation of tract loans frequently includes a master note in the gross amount of the entire project, and a master deed of trust covering all of the land involved in the project. In addition to an appraisal or evaluation for each type of house to be constructed, the bank should also obtain a master appraisal including a feasibility study for the entire development. The feasibility study compares the projected demand for housing against the anticipated supply of housing in the market area of the proposed tract development. This analysis should indicate whether there will be sufficient demand for the developer's homes given the project's location, type of homes, and unit sales price.

Documentation for the Takeout Commitment

Most construction lenders require the developer to have an arrangement for permanent financing for each house to be constructed. Exceptions include model homes, typically one for each style of home offered, and a limited numberof housing starts ahead of sales (speculative houses). The starts ahead of sales, however, contain additional risk. If the bank finances too many houses without purchase contracts, and housing sales decline rapidly, it may have to foreclose on the unsold houses and sell them for less than their loan value. A takeout of this type is usually an arrangement between the developer and a permanent mortgage lender, but construction lenders may also finance the permanent mortgages.

The essential information required for a commercial real estate takeout to proceed includes the floor and ceiling rental rates and minimum occupancy requirements; details of the project being financed; expiration date; standby fee requirement; assignment of rents; and, generally, a requirement that the construction loan be fully disbursed and not in any way in default at the time settlement occurs.

The commitment agreement, referred to as the buy/sell contract or the tri-party agreement, is signed by the borrower, the construction lender, and the permanent lender. The purpose of this agreement is to permit the permanent lender to buy the loan directly from the construction lender upon completion of the construction, with the stipulation that all contingencies have been satisfied. Examples of contingencies include project completion by the required date, clear title to the property, and minimum lease-up requirements. A commitment agreement also protects the construction lender against unforeseen possibilities, such as the death of a principal, before the permanent loan documents are signed.

ADMINISTERING THE LOAN

The bank and the borrower[4] must effectively cooperate as partners if controls relative to construction progress are to be maintained. The loan agreement specifies the performance of each party during the entire course of construction. Any changes in construction plans should be approved by both the construction lender and the takeout lender. Construction changes can result in increased costs, which may not necessarily increase the sale value of the completed project. On the other hand, a decrease in costs may not indicate a savings but may suggest the use of lesser quality materials or workmanship, which could affect the marketability of the project.

Disbursement of Loan Funds

Loan funds are generally disbursed through either a stage payment plan or a progress payment plan. Regardless of the method of disbursement, the amount of each construction draw should be commensurate with the improvements made to date. Funds should not be advanced unless they are used in the project being financed and as stipulated in the draw request. Therefore, the construction lender must monitor the funds being disbursed and must be assured, at every stage of construction, that sufficient funds are available to complete the project.

Stage Payment Plan

The stage payment plan, which is normally applied to residential and smaller commercial construction loans, uses a preestablished schedule for fixed disbursements to the borrower at the end of each specified stage of construction. The amount of the draw is usually based upon the stage of development because residential housing projects normally consist of houses in various stages of construction. Nevertheless, loan agreements involving tract financing

4. The borrower may not be the entity responsible for the actual construction of the project. Depending on the size, type, and complexity of the project, the borrower may strictly be a developer who assembles the land, designs the project, and contracts with a construction company to handle the actual construction of the building. If this is the case, the bank should obtain financial and project history information on the builder/contractor.

typically restrict further advances in the event of an accumulation of completed and unsold houses. Disbursements are made when construction has reached the agreed-upon stages, verified by an actual inspection of the property. These typically include advances at the conclusion of various stages of construction, such as the foundation, exterior framing, the roof, interior finishing, and completion of the house. The final payment is made after the legally stipulated lien period for mechanic's liens has lapsed.

Disbursement programs of this type are usually required for each house constructed within a tract development. As each house is completed and sold, the bank makes a partial release relative to that particular house covered by its master deed of trust. The amount of the release is set forth in the loan agreement, which specifies the agreed-upon release price for each house sold with any excess over the net sales proceeds remitted to the borrower.

Progress Payment Plan

The progress payment plan is normally used for commercial projects.[5] Under a progress payment system, funds are released as the borrower completes certain phases of construction as agreed upon in the loan agreement. Normally, the bank retains a percentage of the funds as a hold back (or retainage) to cover project cost overruns or outstanding bills from suppliers or subcontractors. Hold backs occur when a developer/contractor uses a number of subcontractors and maintains possession of a portion of the amounts owed to the subcontractors during the construction period. This is done to ensure that the subcontractors finish their work before receiving the final amount owed. Accordingly, the construction lender holds back the same funds from the developer/contractor to avert the risk of their misapplication or misappropriation.

The borrower presents a request for payment from the bank in the form of a "construction draw" request or "certification for payment," which sets forth the funding request by construction phase and cost category for work that has been completed. This request should be accompanied by receipts for the completed work (material and labor) for which payment is being requested. The borrower also certifies that the conditions of the loan agreement have been met—that all requested funds have been used in the subject project and that suppliers and subcontractors have been paid. Additionally, the subcontractors and suppliers should provide the bank with lien waivers covering the work completed for which payment has been received. Upon review of the draw request and independent confirmation on the progress of work, the bank will disburse funds for construction costs incurred, less the hold back. The percentage of the loan funds retained are released when a notice of the project's completion has been filed, and after the stipulated period has elapsed under which subcontractors or suppliers can file a lien.

Monitoring Progress of Construction and Loan Draws

It is critical that a bank has appropriate procedures and an adequate tracking system to monitor payments to ensure that the funds requested are appropriate for the given stage of development. The monitoring occurs through physical inspections of the project once it has started. The results of the inspections are then documented in the inspection reports, which are kept in the appropriate file. Depending on the complexity of the project, the inspection reports can be completed either by the lender or by an independent construction consulting firm, the latter generally staffed by architects and engineers. The reports address both the quantity and the quality of the work for which funds are being requested. They also verify that the plans are being followed and that the construction is proceeding on schedule and within budget.

The bank must be accurately informed of the progress to date in order to monitor the loan. It is also important that the bank ascertain whether draws are being taken in accordance with the predetermined disbursement schedule. Before any draw amount is disbursed, however, the bank must obtain verification of continued title insurance. Generally, this means verifying that

5. Other methods for disbursing commercial construction loans include the voucher system and the monthly draw method. The voucher system is similar to the progress system except that borrower prepares a voucher of all invoices to be paid with signatures of the subcontractors attesting to the invoiced amount. The bank then issues checks directly to the subcontractors or suppliers. The monthly draw method is used in long-term projects wherein the borrower makes a draw request each month for the previous month's work. In turn, the bank determines the amount of work completed to date and releases funds based on the value of work completed versus the value of the work remaining.

no liens have been filed against the title of the project since the previous draw. The title insurance insuring the construction lender's mortgage or lien is then increased to include the new draw, which results in an increase in the title insurance commensurate with the disbursement of funds. The lender frequently examines title to the property securing the construction loan to also be certain that the borrower is not pledging it for other borrowings and to be sure that mechanic's liens are not being filed for unpaid bills. When the project is not proceeding as anticipated, that fact should be reflected in the inspection reports.

Another important component in the process is the ongoing monitoring of general economic factors that will affect the marketing and selling of the residential or commercial properties and affect their success upon completion of the project.

Monitoring Residential Projects

An inventory list is maintained for each tract or phase of the project. The inventory list should show each lot number, the style of house, the release price, the sale price, and the loan balance. The list should be posted daily with advances and payments indicating the balance advanced for each house, date completed, date sold, and date paid, and should age the builder's inventory by listing the older houses completed and unsold.

Inspections (usually monthly) during the course of construction of each house should be documented in progress reports. The progress report should indicate the project's activity during the previous month, reflecting the number of homes under construction, the number completed, and the number sold. The monthly report should indicate whether advances are being made in compliance with the loan agreement.

Monitoring Commercial Projects

To have an effective control over its commercial construction loan program, the bank must have an established loan administration process that continually monitors each project. The process should include monthly reporting on the work completed, the cost to date, the cost to complete, construction deadlines, and loan funds remaining. Any changes in construction plans should be documented and reviewed by the construction consulting firm and should be approved by the bank and takeout lender. A significant number of change orders may indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget. Soft costs such as advertising and promotional expenses normally are not funded until the marketing of the project has started.

Final Repayment

Before the final draw is made, the construction loan should be in a condition to be converted to a permanent loan. Usually the final draw includes payment of the hold back stipulated in the loan agreement and is used to pay all remaining bills. The bank should obtain full waivers of liens (releases) from all contractors, subcontractors, and suppliers before the loan is released and the hold back is disbursed. The bank should also obtain a final inspection report to confirm the project is completed and meets the building specifications, including confirmation of the certificate of occupancy from the governing building authority.

Sources of permanent funding for commercial projects vary greatly, depending upon the type of project. For condominium projects, the construction lender may also be providing the funding for marketing the individual units and would be releasing the loan on a unit-by-unit basis similar to a residential development construction loan. If there is a precommitted takeout lender, the new lender could purchase the construction loan documents and assume the security interest from the construction lender. If the project is being purchased for cash, the bank would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the bank's position is protected in the event that extended-term funding is not obtained. The bank may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the bank's interests in the lease by providing for the assumption of the landlord's position by the bank in the event the borrower declares bankruptcy. Furthermore, to ensure that the bank has full knowledge of all provisions of the lease agreements, tenants should be required to sign an estoppel certification.

In some cases, the takeout lender may only pay off a portion of the construction loan because a conditional requirement for full funding has not been met, such as the project not attaining a certain level of occupancy. The construction lender would then have a second mortgage on the remaining balance of the construction loan. When the conditions of the takeout loan are met, the construction lender is repaid in full and the lien is released.

Interest Reserves

A construction loan is generally an interest-only loan because of the fact that cash flow is not available from most projects until they are completed. The borrower's interest expense is therefore borrowed from the construction lender as part of the construction loan for the purpose of "paying" the lender interest on the "portion" of the loan used for actual construction. The funds advanced to pay the interest are included as part of the typical monthly draw. As a result, the balance due to the lender increases with each draw by the full amount of construction costs, plus the interest that is borrowed.

The borrower's interest cost is determined by the amount of credit extended and the length of time needed to complete the project. This interest cost is referred to as an interest reserve. This period of time should be evaluated for reasonableness relative to the project being financed. In larger projects cash flow may be generated prior to the project's completion. In such cases, any income from the project should be applied to debt service before there is a draw on the interest reserve. The lender should closely monitor the lease-up of the project to ensure that the project's net income is being applied to debt service and not diverted to the borrower as a return of the developer's capital or for use in the developer's other projects.

Loan Default

The inherent exposure in construction financing is that the full value of the collateral is not realized until the project is completed. In default situations the bank must consider the alternatives available to recover its advances. For uncompleted projects, the bank must decide whether it is more advantageous to complete the project or to sell on an "as is" basis. The various mechanic's and materialmen's liens, tax liens, and other judgments that arise in such cases are distressing to even the most seasoned lender. Due to these factors, the construction lender may not be in the preferred position indicated by documents in the file. Therefore, the lender should take every precaution to minimize any third-party claim on the collateral. Because laws regarding the priority of certain liens may vary among states, the bank should take the necessary steps to ensure that its lien is recorded prior to the commencement of work or the delivery of materials and supplies.

Signs of Problems

To detect signs of a borrower's financial problems, the bank should review the borrower's financial statements on a periodic (quarterly) basis, assessing the liquidity, debt level, and cash flow. The degree of information the financial statements provide the bank, insofar as understanding the borrower's financial condition is concerned, depends primarily on whether the borrower is a single-asset entity or a multi-asset entity.

The financial statements of a single-asset entity only reflect the project being constructed; therefore, they are of a more limited use than statements of multi-asset entities. Nevertheless, one issue that is of importance to financial statements of both entities relates to monitoring changes in accounts and trade payables. Monitoring these payables in a detailed manner helps the bank to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a bank might choose to either contact the payables directly or request an additional credit check on the borrower. Another source of information indicating borrower problems is local publications that list lawsuits or judgments that have been filed or entered against the borrower. Additionally, the bank should also verify that the borrower is making its tax payments on time.

In a multi-asset entity, on the other hand, more potential problems could arise due to the greater number of assets (projects/properties) that make up the borrower. As a result, it is necessary to obtain detailed financial statements of each of the assets (projects/properties) and the consolidating financial statements, as well as the consolidated financial statements. This is important because each kind of statement can provide significant insight into problems that could adversely affect the borrower's overall financial condition.

Assessing the financial condition of the multi-asset entity includes evaluating the major sources of cash and determining whether cash flow is dependent on income generated from completed projects, the sale of real estate, or infusion of outside capital. Additionally, the bank should also review the borrower's account receivables for the appropriateness of intercompany transactions and to guard against diversion of funds.

Depending upon the structure of the loan, it may also be desirable to obtain a partner's/guarantor's financial statements on a periodic basis. In such cases it is important to obtain detailed current and accurate financial statements that include cash flow information on a project-by-project basis.

Slow unit sales, or excessive inventory relative to sales, indicate the borrower may have difficulty repaying the loan. Although sometimes there are mitigating factors beyond the control of the borrower, such as delays in obtaining materials and supplies, adverse weather conditions, or unanticipated site work, the borrower may be unable to overcome these problems. Such delays usually increase project costs and could hamper the loan's repayment.

The construction lender should be aware of funds being misused—for example, rebuilding to meet specification changes not previously disclosed, starting a new project, or possibly paying subcontractors for work performed elsewhere. The practice of "front loading," whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction, is not uncommon and, if not detected early on, will almost certainly result in insufficient loan funds with which to complete construction in the event of a default.

Loan Workouts

Sound workout programs begin with a full disclosure of all relevant information based on a realistic evaluation of the borrower's ability to manage the business entity (business, technical, and financial capabilities), and the bank's ability to assist the borrower in developing and monitoring a feasible workout/repayment plan. Management should then decide on a course of action to resolve the problems with the terms of the workout in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the bank should ensure that the necessary legal documents are filed to protect the bank's collateral position.

In those cases where the borrower is permitted to finish the project, additional extensions of credit for completing the project, due to cost overruns or an insufficient interest reserve, may represent the best alternative for a workout plan. At the same time, the bank should evaluate the cause of the problem(s), such as mismanagement, and determine whether it is in its best interest to allow the borrower to complete the project.

SUPERVISORY POLICY

As a result of competitive pressures, many banks in the early 1980s made construction loans on an open-end basis, wherein the borrower did not have a commitment for longer-term or takeout financing before construction was started. Although there was sufficient demand for commercial real estate space when this practice commenced, the supply of space began to exceed demand. One symptom of the excess supply was an increase in vacancy rates, which led to declining rental income caused by the ever greater need for rent concessions. The commensurate declining cash flow from income-producing properties, and the uncertainty regarding future income, reduced the market value of many properties to levels considered undesirable by permanent mortgage lenders. As a result of the subsequent void created by the permanent lenders, banks in the mid- and late 1980s began to extend medium-term loans with maturities for up to seven years (also referred to as mini-perms). These mini-perms were granted with the expectation by banks that as the excess supply of space declined, the return on investment would improve, and permanent lenders would return.

As these loans mature in the 1990s, borrowers may continue to find it difficult to obtain adequate sources of long-term credit. In some cases, banks may determine that the most desirable and prudent course is to roll over or renew loans to those borrowers who have demonstrated an ability to pay interest on their debts, but who presently may not be in a position to obtain long-term financing for the loan balance.

The act of refinancing or renewing loans to sound borrowers, including creditworthy commercial or residential real estate developers, generally should not be subject to supervisory criticism in the absence of well-defined weaknesses that jeopardize repayment of the loans. Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and that protects the bank and improves its prospects for collecting or recovering on the asset.

1. To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
2. To determine if bank officers are operating in conformance with the bank's established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine compliance with applicable laws and regulations.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. Refer to the Real Estate Loan Examination Procedures section of this manual for examination procedures related to all types of real estate lending activity, and incorporate into this checklist those procedures applicable to the review of the real estate construction loans. The procedures in this checklist are unique to the review of a bank's construction lending activity.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
3. Test real estate construction loans for compliance with policies, practices, procedures, and internal controls by performing the remaining examination procedures in this section. Also, obtain a listing of any deficiencies noted in the latest internal/external audit reviews and determine if appropriate corrections have been made.
4. Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
5. Evaluate the bank with respect to—
   a. the adequacy of written policies and procedures relating to construction lending.
   b. operating compliance with established bank policy.
   c. favorable or adverse trends in construction lending activity.
   d. the accuracy and completeness of the bank's records.
   e. the adequacy of internal controls, including control of construction draws.
   f. the adherence of lending staff to lending policies, procedures, and authority as well as the bank's adherence to the holding company's loan limits, if applicable.
   g. compliance with laws, regulations, and Federal Reserve policy on construction lending activity, including supervisory loan-to-value (LTV) limits and restrictions; loans to officers, directors, and shareholders; appraisal and evaluation of real estate collateral; and prudent lending practices.
6. Select loans for examination, using an appropriate sampling technique drawn from judgmental (cut-off line) or statistical sampling. Analyze the performance of the loans selected for examination by transcribing the following kinds of information onto the real estate construction loan line cards, when applicable:
   a. Collateral records and credit files, including the borrower's financial statements, review of related projects, credit report of the borrower and guarantors, appraisal or evaluation of collateral, feasibility studies, economic impact studies, and loan agreement and terms.
   b. Loan modification or restructuring agreements to identify loans where interest or principal is not being collected according to the terms of the original loan. Examples include reduction of interest rate or principal payments, deferral of interest or principal payments, or renewal of a loan with accrued interest rolled into the principal.
   c. The commitment agreement—a buy/sell contract or the tri-party agreement—from the extended-term or permanent lender for the takeout loan.
   d. Cash-flow projections and any revisions to projections based on cost estimates from change orders.
   e. Estimates of the time and cost to complete construction.
   f. Inspection reports and evaluations of the cost to complete, construction deadlines, and quality of construction.
   g. Construction draw schedules and audits for compliance with the schedules.
   h. Documentation on payment of insurance and property taxes.
   i. Terms of a completion or performance bond.
   j. Past-due/nonaccrual–related information.
   k. Loan-specific internal problem credit analyses information.
   l. Loans to insiders and their interests.
   m. Loans classified during the preceding examination.
7. In analyzing the selected construction loans, the examiner should consider the following procedures, taking appropriate action if necessary:

a. Determine the primary source of repayment and evaluate its adequacy, including whether—
   - the permanent lender has the financial resources to meet its commitment.
   - the amount of the construction loan and its estimated completion date correspond to the amount and expiration date of the takeout commitment and/or completion bond.
   - the permanent lender and/or the bonding company have approved any modifications to the original agreement.
   - properties securing construction loans that are not supported by a takeout commitment will be marketable upon completion.

b. Analyze secondary support afforded by guarantors and partners.

c. Relate collateral values to outstanding debt by—
   assessing the adequacy of the appraisal and evaluation.
   - ascertaining whether inspection reports support disbursements to date.
   - determining whether the amount of undisbursed loan funds is sufficient to complete the project.
   - establishing whether title records assure the primacy of the bank's liens.
   - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.

d. Determine whether the loan's loan-to-value (LTV) ratio is in excess of the supervisory LTV limits. If so, ascertain whether the loan has been properly reported as a nonconforming loan.

e. Ascertain whether the loan complies with established bank policy.

f. Identify any deficiencies in the loan's documentation in both the credit files and the collateral records.

g. Identify whether the loan is to an officer, director, or shareholder of the bank or a correspondent bank and whether an officer, director, or shareholder of the bank is a guarantor on the loan.

h. Review the borrower's compliance with the provisions of the loan agreement, indicating whether the loan is in default or in past-due status.

i. Determine if there are any problems that may jeopardize the repayment of the construction loan.

j. Determine whether the loan was classified during the preceding examination, and, if the loan has been paid off, whether all or part of the funds for repayment came from another loan at the bank or from the repossession of the property.

8. In connection with the examination of other lending activity in the bank, the examiner should—
   a. check the central liability file on the borrower(s) and determine whether the total construction lending activity exceeds the lending limit to a single borrower.
   b. obtain information and related performance status on common borrowers and their interests from examiners assigned to other examination areas (such as non–real estate loans, leasing, overdrafts, and cash items) and determine the total indebtedness of the borrower to the bank. Additionally, one examiner should be assigned to review the borrower's overall borrowing relationship with the bank.
   c. perform appropriate procedural steps as outlined in the Concentration of Credits section of this manual. Interim construction loans that do not have firm permanent takeout commitments are to be treated as concentrations of credit.

9. Consult with the examiner responsible for the asset/liability management analysis portion of the examination to determine the appropriate maturity breakdown of construction loans needed for the analysis and prepare the necessary schedules.

10. Summarize the findings of the construction loan portfolio review and address—
    a. the scope of the examination.
    b. the quality of the policies, procedures, and controls.
    c. the general level of adherence to policies and procedures.
    d. the competency of management.
    e. the quality of the loan portfolio.
    f. loans not supported by current and complete financial information.
    g. loans with incomplete documentation, addressing deficiencies related to items such as appraisals or evaluations, feasibility studies, the environmental impact study, takeout commitment, title policy, construction plans, inspection reports, change orders, proof of payment for

insurance and taxes, deeds of trust, and mortgage notes.

h. the adequacy of control over construction draws and advances.
i. loans to officers, directors, shareholders, or their interests.
j. causes of existing problems.
k. delinquent loans and the aggregate amount of statutory bad debts. Refer to the manual section on classification of credits for a discussion on statutory bad debts or A Paper.
l. concentrations of credits.
m. classified loans.
n. violations of laws, regulations, and Federal Reserve policy.
o. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the bank's response to such recommendations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing real estate construction loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. 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.

POLICIES AND OBJECTIVES

*1. Has the board of directors and management, consistent with their duties and responsibilities, adopted and, at least annually, reviewed and approved written construction lending policies that—
   a. outline construction lending objectives regarding—
      - the aggregate limit for construction loans?
      - concentrations of credit in particular types of construction projects?
   b. establish minimum standards for documentation?
   c. define qualified collateral and minimum margin requirements?
   d. define the minimum equity requirement for a project?
   e. define loan-to-value (LTV) limits that are consistent with supervisory LTV limits?
   f. require an appraisal or evaluation that complies with the Federal Reserve real estate appraisal regulation and guidelines?
   g. delineate standards for takeout commitments?
   h. indicate completion bonding requirements?
   i. establish procedures for reviewing construction loan applications?
   j. detail methods for disbursing loan proceeds?
   k. detail project-inspection requirements and progress-reporting procedures?
   l. require agreements by borrowers for completion of improvements according to approved construction specifications, and cost and time limitations?
2. Are construction lending policies and objectives appropriate to the size and sophistication of the bank, and are they compatible with changing market conditions?
3. Has the board of directors adopted, and does it periodically review, policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program for the entire bank's lending functions? (The real estate lending functions include commercial real estate mortgage departments, capital-market groups, and asset-securitization and -sales units.)

REVIEWING LOAN APPLICATIONS

1. Does bank policy require a personal guarantee from the borrower on construction loans?
2. Does bank policy require personal completion guarantees by the property owner and/or the contractor?
3. Does the bank require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate which form of equity.
4. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
5. Does the bank require—
   a. background information on the borrower's, contractor's, and major subcontractors' development and construction experience, as well as other projects currently under construction?
   b. payment-history information from suppliers and trade creditors on the aforementioned's previous projects?
   c. credit reports?
   d. detailed current and historical financial statements, including cash flow–related information?

6. Do the borrower's project-cost estimates include—
   a. land and construction costs?
   b. off-site improvement expenses?
   c. soft costs, such as organizational and administrative costs, and architectural, engineering, and legal fees?
   d. interest, taxes, and insurance expenses?
7. Does the bank require an estimated cost breakdown for each stage of construction?
8. Does the bank require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, a construction engineer, or an independent estimator?
9. Are commitment fees required on approved construction loans?

CONSTRUCTION LOAN AGREEMENTS

1. Is the construction loan agreement signed before an actual loan disbursement is made?

*2. Is the construction loan agreement reviewed by counsel and other experts to determine that improvement specifications conform to—
   a. building codes?
   b. subdivision regulations?
   c. zoning and ordinances?
   d. title and/or ground lease restrictions?
   e. health and handicap access regulations?
   f. known or projected environmental protection considerations?
   g. specifications required under the National Flood Insurance Program?
   h. provisions in tenant leases?
   i. specifications approved by the permanent lender?
   j. specifications required by the completion or performance bonding company and/or guarantors?

*3. Does the bank require all change orders to be approved in writing by the—
   a. bank?
   b. bank's counsel?
   c. permanent lender?
   d. architect or supervising engineer?
   e. prime tenants bound by firm leases or letters of intent to lease?
   f. completion bonding company?

4. Does the construction loan agreement set a date for project completion?
5. Does the construction loan agreement require that—
   a. the contractor not start work until authorized to do so by the bank?
   b. on-site inspections be permitted by the lending officer or an agent of the bank without prior notice?
   c. disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving payment and that the appropriate liens are being released?
   d. the bank be allowed to withhold disbursements if work is not performed according to approved specifications?
   e. a percentage of the loan proceeds be retained pending satisfactory completion of the construction?
   f. the lender be allowed to assume prompt and complete control of the project in the event of default? If a commercial project, are the leases assignable to the bank?
   g. the contractor carry builder's risk and workers' compensation insurance? If so, has the bank been named as mortgagee or loss payee on the builder's risk policy?
   h. periodic increases in the project's value be reported to the builder's risk and title insurance companies?
6. Does the construction loan agreement for residential tract construction loans require—
   a. bank authorization for individual tract-housing starts?
   b. that periodic sales reports be submitted to the bank?
   c. that periodic reports on tract houses occupied under a rental, lease, or purchase-option agreement be submitted to the bank?
   d. limitations on the number of speculative houses and the completion of one tract before beginning another?

COLLATERAL

1. Are liens filed on non–real estate construction improvements, i.e., personal property that is movable from the project?
2. When entering into construction loans, does the bank, consistent with supervisory loan-to-value limits—

   a. limit the loan amount to a reasonable percentage of the appraised value of the project when there is no prearranged permanent financing?
   b. limit the loan amount to a percentage of the appraised value of the completed project when subject to the bank's own takeout commitment?
   c. limit the loan amount to the floor of a takeout commitment that is based upon achieving a certain level of rents or lease occupancy?
3. Are unsecured credit lines to contractors or developers, who are also being financed by secured construction loans, supervised by the construction loan department or the officer supervising the construction loan?
4. Does the bank have adequate procedures to determine whether construction appraisal or evaluation policies and procedures are consistently being followed in conformance with regulatory requirements, and that the appraisal or evaluation documentation supports the value indicated in the conclusions?

INSPECTIONS

1. Are inspection authorities noted in the—
   a. construction loan commitment?
   b. construction loan agreement?
   c. tri-party buy-and-sell agreement?
   d. takeout commitment?
2. Are inspections conducted on an irregular basis?
3. Are inspection reports sufficiently detailed to support disbursements?
4. Are inspectors rotated from project to project?
5. Are spot checks made of the inspectors' work?
6. Do inspectors determine compliance with plans and specifications as well as the progress of the work? If so, are the inspectors competent to make the determination?

DISBURSEMENTS

*1. Are disbursements—
   a. advanced on a prearranged disbursement plan?
   b. made only after reviewing written inspection reports?
   c. authorized in writing by the contractor, borrower, inspector, subcontractors, and/or lending officer?
   d. reviewed by a bank employee who had no part in granting the loan?
   e. compared with original cost estimates?
   f. checked against previous disbursements?
   g. made directly to subcontractors and suppliers?
   h. supported by invoices describing the work performed and the materials furnished?
2. Does the bank obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
3. Does the bank obtain sworn and notarized releases of mechanic's liens from the general contractor at the time construction is completed and before final disbursement is made?
4. Does the bank periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
5. Are the borrower's undisbursed loan proceeds and contingency or escrow accounts independently verified at least monthly by someone other than the individuals responsible for loan disbursements?

TAKEOUT COMMITMENTS

1. Does counsel review takeout agreements for acceptability?
2. Does the bank obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
3. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
4. Does the bank require takeout agreements to include a force majeure—an act-of-God clause—that provides for an automatic extension of the completion date in the event that construction delays occur for reasons beyond the builder's control?

COMPLETION BONDING REQUIREMENTS

1. Does the bank require completion insurance for all construction loans?

2. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?
3. Does counsel review completion insurance bonds for acceptability?

DOCUMENTATION

1. Does the bank require and maintain documentary evidence of—
   a. the contractor's payment of—
      - employee withholding taxes?
      - builder's risk insurance?
      - workers' compensation insurance?
      - public liability insurance?
      - completion insurance?
   b. the property owner's payment of real estate taxes?
2. Does the bank require that documentation files include—
   a. loan applications?
   b. financial statements for the—
      - borrower?
      - builder?
      - proposed prime tenant?
      - takeout lender?
      - guarantors/partners?
   c. credit and trade checks on the—
      - borrower?
      - builder?
      - major subcontractor?
      - proposed tenants?
   d. a copy of plans and specifications?
   e. a copy of the building permit?
   f. a survey of the property?
   g. the construction loan agreement?
   h. an appraisal or evaluation and feasibility study?
   i. an up-to-date title search?
   j. the mortgage?
   k. ground leases?
   l. assigned tenant leases or letters of intent to lease?
   m. a copy of the takeout commitment?
   n. a copy of the borrower's application to the takeout lender?
   o. the tri-party buy-and-sell agreement?
   p. inspection reports?
   q. disbursement authorizations?
   r. undisbursed loan proceeds and contingency or escrow account reconcilements?
   s. insurance policies?
3. Does the bank employ standardized checklists to control documentation for individual files, and does it perform audit reviews for adequacy?
4. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the bank, and include a summary of other construction projects being financed by other banks? Does the bank analyze the status of these projects and the potential effect on the borrower's financial position?
5. Does the bank use tickler files that—
   a. control scheduling of inspections and disbursements?
   b. ensure prompt administrative follow-up on items sent for—
      - recording?
      - an attorney's opinion?
      - an expert review?
6. Does the bank maintain tickler files that provide advance notice (such as 30 days' prior notice) to staff of the expiration dates for—
   a. the takeout commitment?
   b. hazard insurance?
   c. workers' compensation insurance?
   d. public liability insurance?

LOAN RECORDS

*1. Are the preparation, addition, and posting of subsidiary real estate construction loan records performed or adequately reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
   c. reconcile subsidiary records to general ledger controls?

*2. Are the subsidiary real estate construction loan records reconciled at least monthly to the appropriate general ledger accounts? Are reconciling items adequately investigated by persons who do not also handle cash or prepare/post subsidiary controls?

*3. Are loan statements, delinquent account-collection requests, and past-due notices reconciled to the real estate construction loan subsidiary records? Are the reconciliations handled by a person who does not also handle cash?

4. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?

*5. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
6. Is a delinquent-accounts report generated daily?
7. Are loans in excess of supervisory LTV limits identified in the bank's records, and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
8. Does the bank maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
9. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

LOAN INTEREST AND COMMITMENT FEES

*1. Are the preparation and posting of loan interest and fee records performed or adequately reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
2. Are any independent interest and fee computations made and compared with or adequately tested to loan interest by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

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. On the basis of a composite evaluation, are internal controls adequate as evidenced by answers to the foregoing questions?

INTRODUCTION

This manual section provides a brief summary of the Board's appraisal regulations and directs readers to the key pieces of guidance that the Board and other banking agencies have issued relating to real estate appraisals and evaluations. The Board's real estate appraisal regulation is found in Regulation Y, subpart G (12 CFR 225.61–67). For state member banks, there is a cross reference to the Board's appraisal regulations in Regulation H (12 CFR 208.50–51). Appraisals are also discussed in the Interagency Guidelines for Real Estate Lending Policies, which are found in Appendix C to Regulation H, (Appendix C to 12 CFR 208). The Board's real estate lending standards (12 CFR 208 Subpart E) direct federally regulated institutions to adopt and maintain written real estate lending policies that are consistent with safe and sound lending practices. Such policies should reflect consideration of applicable regulations and guidance pertaining to real estate appraisals when developing a loan-to-value estimate.[1]

REGULATORY BACKGROUND FOR APPRAISALS

The Board's policy on real estate appraisals emphasizes the importance of sound appraisal policies and collateral-valuation procedures as part of a bank's real estate lending activity. The Board and other federal financial regulatory agencies adopted regulations in August 1990 on the performance and use of appraisals by federally regulated financial institutions to implement statutory changes due to the passage of title XI (title XI) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (12 USC 3331 et seq.).[2]

The Board's appraisal regulation requires, at a minimum, that real estate appraisals for federally related transactions be performed in accordance with the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board (ASB) of the Appraisal Foundation, and that appraisals be in writing.[3] The regulation also sets forth additional appraisal standards including that the appraisal contain sufficient information and analysis to support the bank's decision to engage in the transaction, provide the real property's market value, be performed by state certified or licensed appraisers as required by the regulations and analyze deductions and discounts for proposed construction projects, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.

The intent of title XI and the Board's appraisal regulation is to protect federal, financial, and public policy interests in federally related transactions.[4] Federally related transactions are defined as those real estate-related financial transactions that an agency engages in, contracts for, or regulates and that require the services of an appraiser.[5]

Appraisals are required under the appraisal regulation for all real estate-related financial transactions unless an exemption applies. The regulation contains a set of exemptions, including dollar value thresholds at or below which an appraisal is not required. The exemptions are identified as categories of real estate-related financial transactions that do not require the services of an appraiser in order to protect federal financial and public policy interests or to satisfy principles of safe and sound banking. As such, the exempted transactions are not federally related transactions under the statutory and regulatory definitions. Exempted transactions are not subject to title XI nor the provisions of the agencies' regulations governing appraisals. Certain exemptions, however, require the use of an evaluation consistent with safe and sound banking practices. Interagency guidance has been issued to assist financial institutions in performing evaluations consistent with such practices.

In addition to federal regulations, each state has established a program for certifying and licensing real estate appraisers who are qualified to perform appraisals in connection with federally related transactions. Title XI designated the Appraiser Qualifications Board and the ASB of

1. 12 CFR 208, appendix C defines "value" when used to refer to "loan-to-value" as an opinion or estimate set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared in accordance with the agency's appraisal regulations and guidance.

2. In June 1994, the agencies' appraisal regulations were materially revised to clarify, amend, and add several exemptions to the appraisal requirement of regulation.

3. See 12 CFR 225.64.

4. See 12 USC 3331.

5. See 12 USC 3350(4).

the Appraisal Foundation, a nonprofit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and licensing and the standards for the preparation of an appraisal. Title XI established the Appraisal Subcommittee (ASC) of the Federal Financial Institutions Examination Council (FFIEC). The ASC monitors state requirements for certifying and licensing appraisers who can perform appraisals for federally related transactions, state supervision, and registration of appraisal management companies, and certain title XI-related requirements established by the federal financial regulatory agencies. The ASC also monitors the Appraisal Foundation and its entities. If the ASC issues a finding that the policies, practices, or procedures of a state appraiser certifying and licensing agency are inconsistent with title XI, the services of licensed or certified appraisers from that state may not be used in connection with federally related transactions. The ASC also maintains the national registry of appraisers and appraisal management companies.[6]

THE APPRAISAL REGULATION

Regulation Y, 12 CFR 225, Subpart G, Appraisal Standards for Federally Related Transactions

The appraisal regulation sets standards for appraisals in connection with federally related transactions and also contains a lists of transactions that do not require the services of an appraiser and, therefore, are exempt from the appraisal requirement of the regulation. In reviewing a real estate loan, examiners assess whether the appraisal supports the real estate value used by the bank in its credit decision and whether the appraisal complies with the appraisal regulation. Further, examiners assess the adequacy of an institution's appraisal program to support its real estate lending activity. There are several key sections in the appraisal regulation, which are described in greater detail below.

6. Several provisions in title XI of FIRREA were amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), providing additional authority to the ASC in its oversight of states' appraiser regulatory programs. (See sections 1471-1473 of Pub. L. 111-203, 124 Stat. 1376 (2010).)

The regulation contains the following:

- Minimum appraisal standards, Section 225.64
  The regulation establishes minimum standards necessary for all appraisals that are prepared for federally related transactions. Those appraisals must
  - conform to generally accepted appraisal standards in USPAP.
  - be written and contain sufficient information and analysis to support the credit decision.
  - analyze and report deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms and tract developments with unsold units.
  - be based upon the definition of market value set forth in the definition section of the regulation.
  - be performed by state-licensed or state-certified appraisers in accordance with the regulation.

- Independence standards for staff appraisers and fee appraisers, Section 225.65
  - Staff appraisers must be independent of the lending, investment, and collection functions of the institution and not involved, except as an appraiser, in the federally related transaction and have no direct or indirect interest, financial or otherwise, in the property.
  - Fee appraisers must be engaged directly by the institution or its agent and have no direct or indirect interest, financial or otherwise, in the property or the transaction.
  - The regulation allows an institution to accept an appraisal prepared by an appraiser engaged by another financial services institution if the appraiser has no direct or indirect interest, financial or otherwise, in the property or transaction, and the appraisal complies with the requirements of the regulation.

- Exemptions from the Regulation, Section 225.63
  - The regulation provides a list of transactions that do not require appraisals. These transactions do not require the services of an appraiser and are, therefore, not federally related transactions. Certain of these

exceptions require an evaluation in lieu of an appraisal.

- Standards for professional association membership and competency, Section 225.66
  - — A state-certified or state-licensed appraiser may not be excluded from consideration of an assignment based on membership or lack of membership in a particular appraisal organization.
  - — All staff and fee appraisers performing appraisals in connection with federally related transactions must be state-certified or state-licensed as appropriate. However any determination of competency shall be based on the individual's experience and educational background as they relate to a particular appraisal assignment.
- Enforcement actions, Section 225.67
  - — Institutions and their affiliates, including staff and fee appraisers, may be subject to removal and/or prohibition orders, cease and desist orders, and the imposition of civil money penalties.

SUPERVISORY EXPECTATIONS AND FINDINGS

In conjunction with assessing the overall adequacy of a bank's appraisal and evaluation program to support safe-and-sound real estate lending, examiners may cite a bank with the following possible findings.

1. Examiners may make a finding regarding the bank's compliance with the Board's appraisal regulation. When citing a violation of the appraisal regulation for a state member bank, an examiner should note the matter as a violation of Regulation H (12 CFR 208, subpart E) citing the provision as codified in Regulation Y.
2. In some instances, the finding may indicate that the bank has failed to comply with the Board's real estate lending standards regulation. Examiners may refer to 12 CFR 208, Appendix C, "Interagency Guidelines for Real Estate Lending Policies," for guidance related to the use of appraisals in developing loan-to-value estimates according to the real estate lending standards.
3. Examiners should consider the supervisory expectations in the Interagency Appraisal and Evaluation Guidelines for guidance on safe-and-sound valuation policies and practices. If the institution's valuation policies and practices pose safety and soundness concerns for the institution, examiners could refer to 12 CFR 208, Appendix D-1, "Interagency Guidelines Establishing Standards for Safety and Soundness," for guidance on consideration of the value of underlying collateral.

The following provides examples of possible examination findings and references to the applicable provisions in the Board's regulations.

- Examples of violations of the appraisal regulation, 12 CFR 208.50 as set forth in 12 CFR 225.61–67, include
  - — failure to obtain an appraisal (12 CFR 225.63);
    - ○ not obtaining an appraisal as required by the regulation
    - ○ using an outdated appraisal for an existing transaction without meeting the regulatory criteria
    - ○ not obtaining an appraisal due to the misapplication of an exemption, or when the transaction does not meet the specific requirements of the exemption
    - ○ Remedy: Examiners should require the bank to obtain a new appraisal.
  - — appraisal fails to comply with the minimum appraisal standards in the appraisal regulation;
    - ○ violation of 12 CFR 208.50, subpart E as set forth in 12 CFR 225.64 (minimum appraisal standards) or 12 CFR 225.65 (appraiser independence)
    - ○ Remedy: Examiners should require the bank to obtain a new appraisal.
  - — failure to use a state-licensed or state-certified appraiser (12 CFR 225.63);
    - ○ engaging an appraiser with an expired license or certification
    - ○ engaging a state-licensed appraiser when a state-certified appraiser is required
    - ○ Remedy: Examiners should require the bank to obtain a new appraisal.
  - — failure to maintain appraiser independence (12 CFR 225.65); and
    - ○ using a staff appraiser that is not independent of the lending function
    - ○ allowing the borrower to hire the appraiser (the regulation requires that

fee appraisers be engaged directly by the institution or its agent)
  - ○ using an appraisal prepared by an appraiser that has an interest in the real estate
  - ○ Remedy: Examiners should require the bank to obtain a new appraisal.
- — failure to obtain an evaluation for certain exempt transactions (12 CFR 225.63(b)).
  - ○ not obtaining an evaluation for a renewed loan
  - ○ not obtaining an evaluation for a commercial or residential transaction at or under the appropriate threshold
  - ○ not obtaining an evaluation for a business loan at or under $1 million
  - ○ For further background, refer to the Interagency Guidelines and the section on "Transactions That Require Evaluations" as well as Appendix A—Appraisal Exemptions.
  - ○ Remedy: Examiners should require the bank to obtain an evaluation.

• Examples of violations of the real estate lending regulation 12 CFR 208, subpart E that pertain to appraisals or evaluations:
  - — The bank does not have adequate procedures for monitoring market conditions for its commercial real estate lending.
    - ○ A bank must monitor real estate market conditions in its lending area and have credit administration policies that address the type and frequency of collateral valuations. Violation of 12 CFR 208, subpart E (real estate lending standards regulation).
  - — Bank does not have appropriate policies establishing loan-to-value limits for real estate collateral. Violation of 12 CFR 208, subpart E (real estate lending standards regulation).
  - — Remedy: Examiners should require the bank to implement policies and procedures to promote compliance with the real estate lending regulation.

• Examples of possible safety and soundness violations:
  - — The bank's overall appraisal function is weak.
    - ○ The bank has failed to satisfy supervisory expectations for appraisal and evaluation programs. Guidance on developing appraisal and evaluation programs in a safe-and-sound manner is provided in the Interagency Appraisal and Evaluation Guidelines.
    - ○ The bank's approach to monitoring collateral values raises concerns for the safety and soundness of the institution. For guidance, see in the section of the safety and soundness guidelines, 12 CFR 208, Appendix D-1, which pertains to collateral value.
  - — The evaluation is inadequate.
    - ○ The bank has failed to satisfy supervisory expectations for evaluations.
    - ○ For further guidance, refer to the Interagency Guidelines, the "Evaluation Development" and "Evaluation Content" subsections, and Appendix B —Evaluations Based on Analytical Methods or Technological Tools.
    - ○ Remedy: Depending upon the noted deficiencies, examiners should require the bank to perform a new evaluation.
  - — The bank has failed to maintain independence expectations for its appraisal and evaluation program. Guidance for doing so is set forth in the section on the Independence of the Appraisal and Evaluation Program in the Interagency Guidelines.
    - ○ Evaluations are prepared by persons who are not independent of loan production.
    - ○ Reporting lines of valuation program staff are not independent of loan production.

INTERAGENCY APPRAISAL AND EVALUATION GUIDELINES

Over the years, the Board and the other federal banking regulatory agencies (the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation (the agencies)) have issued several appraisal-related guidance documents to assist institutions in implementing and complying with the appraisal regulation.[7] In December 2010, the agencies issued the Interagency Appraisal and Evaluation Guidelines (Interagency Guidelines) to clarify their appraisal regulations and to promote best practices in institutions' appraisal and evaluation programs.

7. For more information, see the "Real Estate" supervisory policy and guidance topic page.

(See SR 10-16.) The Interagency Guidelines pertain to all real estate-related financial transactions originated or purchased by a regulated institution or its operating subsidiary for its own portfolio or as assets held for sale, including activities of commercial and residential real estate mortgage operations, capital markets groups, and asset securitization and sales units. The Interagency Guidelines provide a comprehensive discussion of the Board's supervisory expectations for a bank's appraisal and evaluation program as well as background information on the technical aspects of appraisals.

The Interagency Guidelines more fully explain and clarify the requirements of the appraisal regulation. The Interagency Guidelines also contain supervisory guidance for developing and maintaining a safe-and-sound appraisal and evaluation program. Expectations for evaluations are addressed in the guidelines to clarify the requirement in the regulation that evaluations be performed in a safe-and-sound manner. For example, the appraisal regulation allows for the substitution of an "appropriate evaluation" for an appraisal under certain transactions; however, the regulation does not define what is an appropriate evaluation. The Interagency Guidelines provide guidance to assist regulated institutions in determining what an "appropriate evaluation" is. A violation of the appraisal regulation should be cited if the bank failed to obtain an evaluation, where one was required. The Interagency Guidelines may be used as guidance, for example, in determining the appropriate type of content in an evaluation. However, in making determinations about the adequacy of an institution's evaluation content, an assessment of the impact on the safety and soundness of the institution should be made and if it is determined that safety and soundness of the institution was negatively impacted, the safety and soundness guidelines should be cited. The Interagency Guidelines serve two main purposes:

1. Provides guidance regarding supervisory expectations for a bank's appraisal and evaluation program including that
   - the institution's board of directors should provide for an effective appraisal and evaluation program;
   - the program should be independent;
   - the program should have a criteria for selection of appraisers and evaluators;
   - appraisals and evaluations should be appropriately reviewed;
   - there should be appropriate oversight of third party arrangements;
   - the lender should have an appropriate compliance program; and
   - the lender should report appraisers that are involved in USPAP violations to state appraisal regulatory agencies.

2. Clarifies and provides guidance to assist firms in complying with the appraisal regulation, such as
   - the content expectations of an evaluation;
   - independence expectations for evaluations;
   - transactions that are exempt from the appraisal requirement;
   - situations where a real estate loan does not qualify for an exemption;
   - assessing the validity of existing appraisals and evaluations;
   - the importance of a scope of work and valuation approach in appraisal development; and
   - appraisal report options.

The Interagency Guidelines also discuss other uses for appraisals and evaluations. For example, a bank's collateral-valuation program should consider when an appraisal or evaluation should be obtained to monitor ongoing collateral risk and to support credit analysis, including for purposes of updating risk ratings or classifying the credit. Also, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's cash flow and income to the expected proceeds from the sale of the real estate collateral. Therefore, it is important that banks have a sound and independent basis for determining the ongoing value of the real estate collateral. (See SR letter 09-7, "Prudent Commercial Real Estate Loan Workouts.")

Appendixes of Interagency Appraisal and Evaluation Guidelines

Below are summaries of the four appendixes included with the guidelines found in the attachment to SR 10-16.

Appendix A—Appraisal Exemptions. A commentary on the 12 exemptions from the agencies' appraisal regulations. The appendix provides an explanation of the agencies' statutory authority to provide for appraisal regulatory exemptions and the application of these exemptions.

Appendix B—Evaluations Based on Analytical Methods and Technological Tools. A discussion of the agencies' expectations for evaluations that are based on analytical methods and technological tools, including the use of automated valuation models and tax assessment valuations.

Appendix C—Deductions and Discounts Minimum. A discussion on appraisal standards for determining the market value of a residential tract development, including an explanation of the requirement to analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units.

Appendix D—Glossary. Definitions of terms related to real estate lending, appraisals, and regulations to aid in reading the guidelines.

ASSESSING THE ADEQUACY OF AN APPRAISAL

When assessing the adequacy of an appraisal and its compliance with the minimum appraisal standards, examiners should assess whether the appraisal conforms to USPAP Standard Rule 1—Real Property Appraisal Development, and USPAP Standard Rule 2—Real Property Appraisal Reporting. The Interagency Guidelines discuss the importance of the appraiser developing an appropriate "scope of work" consistent with USPAP's Scope of Work rule. An appraisal's scope of work should be clearly developed and explained in the appraisal report. Further, the appraisal report should include a copy of the bank's engagement letter with the appraiser for the appraisal assignment.

It is important to note that some of the USPAP standards differ from aspects of the appraisal regulation, and, in such cases, the appraisal regulation should be followed with respect to appraisals for federally related transactions. For example, USPAP does not require appraiser independence and allows for appraisals to address different definitions of value other than market value.

In reviewing a real estate loan and the related appraisal, examiners should consider whether the type of appraisal report is acceptable, the valuation approach is appropriate for the transaction, and the appraisal contains an estimate based on the market value definition. The appraisal should contain a clear development of the market value of the collateral and should contain sufficient information to support the real estate's market value and the bank's credit decision. The USPAP standards discuss all of the basic components of an appraisal. Residential appraisals are commonly completed in a report format that conforms to the Uniform Residential Appraisal Report, which was developed by Fannie Mae and Freddie Mac.

Examiners should also confirm that the bank has procedures for reviewing appraisals and evaluations to determine that an appraisal or evaluation complies with the appraisal regulation and provides sufficient information to support the bank's credit decision. The Interagency Guidelines provide further guidance on appropriate reviews. Not all appraisal reviews need to include the content of a USPAP Standard 3—Appraisal Review, Development, and Reporting. The depth of the appraisal review performed by the bank should consider the complexity and risk of the transaction. If deficiencies are noted in the bank's review process, a bank should obtain a USPAP compliant review completed by an appraiser or obtain a new compliant appraisal. Banks are encouraged to report to the state appraiser regulatory agency any appraiser that violates USPAP standards.

APPRAISAL VALUATION APPROACHES

An appraiser typically utilizes three market-value approaches to analyze the value of property:[8]

- *cost approach*
- *sales comparison approach*
- *income approach*

Appraisers should consider all three approaches to value when completing an appraisal assignment. All three approaches have particular merits depending upon the type of real estate being appraised. For example, for single-family resi-

8. The standards and application of valuation approaches are contained in the USPAP published by the Appraisal Standards Board of the Appraisal Foundation.

dential property, the cost and comparable sales approaches are most frequently used since the common use of the property is the personal residence of the owner. However, if a single-family residential property were intended to be used as a rental property, the appraiser would have to consider the income approach as well. Commercial properties are typically valued using all three approaches to value, however the income approach is heavily favored for property whose primary source of income is derived from rents. The appraiser then correlates the results of the value considerations to determine a market value for the subject real estate. For special-use commercial properties, the appraiser may have difficulty obtaining sales data on comparable properties and may have to base the value estimate on the cost and income approaches.

If an approach is not used in the appraisal, the appraiser should disclose the reason the approach was not used and whether this affects the value estimate.

Cost Approach

The cost approach is commonly used to value construction or improvements to an existing building. In the cost approach to value estimation, the appraiser obtains a preliminary indication of value by adding the estimated depreciated reproduction cost of the improvements to the estimated land value. This approach is based on the assumption that the reproduction cost is the upper limit of value and that a newly constructed building would have functional and mechanical advantages over an existing building. The appraiser would evaluate any functional depreciation (disadvantages or deficiencies) of the existing building in relation to a new structure.

The cost approach consists of four basic steps: (1) estimate the value of the land as though vacant, (2) estimate the current cost of reproducing the existing improvements, (3) estimate depreciation and deduct from the reproduction cost estimate, and (4) add the estimate of land value and the depreciated reproduction cost of improvements to determine the value estimate.

SALES COMPARISON APPROACH

The essence of the sales comparison approach is to determine the price at which similar properties have recently sold on the local market. Through an appropriate adjustment for differences in the subject property and the selected comparable properties, the appraiser estimates the market value of the subject property based on the sales price of the comparable properties. The process used in determining the degree of comparability of two or more properties involves judgment about their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tends to set the range for the value of the subject property.

Income Approach

The income approach estimates the real estate project's expected income over time converted to an estimate of its present value. The income approach is typically used to determine the market value of income-producing properties that receive rent, such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can apply several different capitalization or discounted cash-flow techniques to arrive at a market value. These techniques include the band-of-investments method, mortgage-equity method, annuity method, and land-residual method. Which method is used depends on whether there is project financing, whether there are long-term leases with fixed-level payments, and whether the value is being rendered for a component of the project, such as land or buildings.

The accuracy of the income-approach method depends on the appraiser's skill in estimating the anticipated future net income of the property and in selecting the appropriate capitalization rate and discounted cash flow. The following data are assembled and analyzed to determine potential net income and value:

- Rent schedules and the percentage of occupancy for the subject property and for comparable properties for the current year and several preceding years. This provides gross rental data and shows the trend of rentals and occupancy, which are then analyzed by the appraiser to estimate the gross income the property should produce.

- Expense data, such as taxes, insurance, and operating costs paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined.
- A time frame for achieving stabilized, or normal, occupancy and rent levels (also referred to as a holding period).

Basically, the income approach converts all expected future net operating income into present-value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is used to value income properties. This method calculates the value of a property by dividing an estimate of its stabilized annual income by a factor called a capitalization rate or "cap rate." Stabilized income is generally defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The cap rate—usually defined for each property type in a market area—is viewed by some analysts as the required rate of return stated as a percentage of current income.

The use of this technique assumes that the use of either the stabilized income or the cap rate accurately captures all relevant characteristics of the property relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization should yield the same results. For special-use properties, new projects, or troubled properties, the discounted cash flow (net present value) method is the more typical approach to analyzing a property's value. In this method, a time frame for achieving a stabilized, or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Most importantly, the analysis should be based on the ability of the project to generate income over time based upon reasonable and supportable assumptions. Additionally, the discount rate should reflect reasonable expectations about the rate of return that investors require under normal, orderly, and sustainable market conditions.

Value Correlation

The three value estimates—cost, sales comparison, and income—must be evaluated by the appraiser and correlated into a final value estimate based on the appraiser's judgment. Correlation does not imply averaging the value estimates obtained by using the three different approaches. Where these value estimates are relatively close together, correlating them and setting the final market value estimate presents no special problem. It is in situations where widely divergent values are obtained by using the three appraisal approaches that the examiner must exercise judgment in analyzing the results and determining the estimate of market value.

Other Definitions of Value

While the Board's appraisal regulation requires that the appraisal contain the market value of the real estate collateral, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include the following:

Fair value. This is an accounting term that is generally defined as the amount in cash or cash-equivalent value of other consideration that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (the selling price), that is, other than in a forced or liquidation sale.[9] According to accounting litera-

9. See Accounting Standards Codification (ASC) Topic 820, "Fair Value Measurements and Disclosures" (formerly FASB Statement No. 157, "Fair Value Measurements"). It defines fair value and establishes a framework for measuring fair value. ASC Topic 820 should be applied when other accounting topics require or permit fair value measurements. Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants in the asset's or liability's principal (or most advantageous) market at the measurement date. This value is often referred to as an "exit" price. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced

ture, fair value is generally used in valuing assets in nonmonetary transactions, troubled debt restructuring, quasi-reorganizations, and business combinations accounted for by the purchase method. An accountant generally defines fair value as market value; however, depending on the circumstances, these values may not be the same for a particular property.

Investment value. This is based on the data and assumptions that meet the criteria and objectives of a particular investor for a specific property or project. The investor's criteria and objectives are often substantially different from participants' criteria and objectives in a broader market. Thus, investment value can be significantly higher than market value in certain circumstances and should not be used in credit analysis decisions.

Liquidation value. This assumes that there is little or no current demand for the property but the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

Going-concern value. This is based on the value of a business entity rather than the value of just the real estate. The valuation is based on the existing operations of the business that has a proven operating record, with the assumption that the business will continue to operate.

Tax-assessed value. This represents the value on which a taxing authority bases its assessment. The assessed value and market value may differ considerably due to tax assessment laws, timing of reassessments, and tax exemptions allowed on properties or portions of a property.

Net realizable value (NRV). This is recognized under generally accepted accounting principles as the estimated selling price in the ordinary course of business less estimated costs of completion (to the stage of completion assumed in determining the selling price), holding, and disposal. The NRV is generally used to evaluate the carrying amount of assets being held for disposition and properties representing collateral. While the market value or future selling price are generally used as the basis for the NRV calculation, the NRV also reflects the current owner's costs to complete the project and to hold and dispose of the property. For this reason, the NRV will generally be less than the market value.

liquidation or distressed sale.

1. Is the appraisal and evaluation program adequate for the size, complexity, and nature of the bank's real estate related activities?
2. Is the appraisal and evaluation program independent from the loan production process?
3. Do the bank's policies ensure that appraisals and evaluations meet minimum standards?
4. Does the bank have appropriate procedures for updating appraisals as needed?
5. Does the bank have an appropriate appraisal review program?
6. Does the bank take appropriate actions to ensure compliance with the appraisal program expectations?
7. Does the bank appropriately oversee third parties involved in the appraisal process?
8. Does the bank have policies and procedures to ensure the independence of staff and fee appraisers?
9. Does the bank have policies to ensure that appraisers meet licensing and competency standards?

PRELIMINARY REVIEW

1. Review the following documents:

   - Prior examination reports, prior examination work papers, pre-examination memorandum, and file correspondence (for an overview of previously identified program deficiencies, violations, and concerns);
   - Internal and external loan reviews (look for individual real estate appraisal issues);
   - Appraisal and evaluation policies and procedures;
   - Internal and external reviews of the adequacy of the real estate appraisal and evaluation program;
   - List of board-approved appraisers;
   - Log of all appraisal engagements for each appraiser for the current and prior year; and
   - Organizational charts and reporting structures with respect to the institution's appraisal and evaluation program. (Note: Review the institution's organizational structure to understand better whether its program is isolated from influence by the loan production staff or if mitigating controls are in place for institutions with a small staff size.)

SUPERVISORY POLICY

2. Determine whether the institution's appraisal and evaluation program is adequate for the size, complexity, and nature of its real estate related activities.

APPRAISAL AND EVALUATION PROGRAM

3. Determine whether the institution's board of directors established policies and procedures to review and revise its program as necessary.

INDEPENDENCE OF THE APPRAISAL AND EVALUATION PROGRAM

4. Determine whether the institution's appraisal and evaluation program is independent from loan production and collection. Consider whether policies and procedures address the following:

   - Individuals providing evaluation services should be prohibited from having an interest, financial or otherwise, in the property or the transaction.
   - Reporting lines for staff who administer the appraisal and evaluation program (including the ordering, reviewing, and acceptance of appraisals and evaluations) should be independent of loan production.
   - Management should establish safeguards (if absolute lines of independence cannot be achieved) to isolate its program from influence from the loan production process and to ensure that any person who ordered or reviewed the appraisal or evaluation abstains from decisions on loan approvals.

SELECTION OF APPRAISERS OR PERSONS WHO PERFORM EVALUATIONS

5. Determine whether the appraisal and evaluation program has criteria for selecting, evaluating, and monitoring the performance of appraisers and persons who perform evaluations. Determine whether policies and procedures appropriately address

   - the documented assessment of whether the appraiser or person performing an evaluation is competent, independent, and has adequate experience and knowledge of the market, location, and type of property being valued;
   - the development and administration of the approved appraiser list that include a process for
     — qualifying an appraiser for initial placement on the list, and
     — monitoring the appraiser's perfor-

mance and credentials to assess whether to retain the appraiser on the list;

- safeguards for developing and administering the approved appraiser list independent of the loan production process;
- the use of written engagement letters when ordering appraisals, particularly for large, complex, or out-of-area commercial real estate properties; and
- the acceptance of appraisal reports performed for another financial institution.

TRANSACTIONS THAT REQUIRE APPRAISALS

6. Determine whether an appraisal or evaluation that supports the lending decision, or an explanation why a new appraisal or evaluation was not required, is contained in the credit files or is available.

MINIMUM APPRAISAL STANDARDS

7. Determine whether the institution has procedures and internal controls that ensure appraisals for federally related transactions

   - conform to generally accepted appraisal standards as evidenced by the USPAP promulgated by the Appraisal Standards Board of the Appraisal Foundation;
   - contain sufficient information and analysis to support the institution's decision to engage in the transaction;
   - analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units;
   - use definitions of market value set forth in the appraisal regulation; and
   - are performed by state-licensed or state-certified appraisers in accordance with the requirements set forth in the appraisal regulation.

8. Determine whether the program prohibits the use of a broker price opinion in connection with consumer transactions.

APPRAISAL DEVELOPMENT

9. Determine whether the institution considers the risk, size, and complexity of the transaction and real estate collateral when analyzing an appraisal. Consider whether policies and procedures ensure appraisals have an appropriate scope that provides for credible assignment results. Appraisals should reflect

   - the extent to which the property is identified and inspected,
   - the type and extent of data researched, and
   - the analyses applied to arrive at opinions or conclusions.

APPRAISAL REPORTS

10. Determine whether the institution considers the risk, size, and complexity of the transaction and the real estate collateral when requesting the appraisal report format. Appraisal reports should contain sufficient information and analysis to support the institution's decision to engage in the transaction.

TRANSACTIONS THAT REQUIRE EVALUATIONS

11. Determine whether the institution established criteria for when the appraisal regulations permit the use of an evaluation in lieu of an appraisal for transactions that qualify for certain exemptions.

    - Although appraisal regulations permit the use of evaluations for certain transactions, ensure the institution has policies and procedures for determining when to obtain an appraisal for high-risk transactions.

EVALUATION DEVELOPMENT

12. Determine whether evaluations provide credible estimates of collateral market values as of a specific date and are completed prior to the decision to enter into a transaction. Consider

- the institution's documentation requirements for ensuring the sufficiency of information and analysis to support the estimate of value for a given transaction.
- the institution's criteria for determining the level and extent of research or inspection necessary to ascertain the property's physical condition and the economic and market factors that should be considered in developing an evaluation.

EVALUATION CONTENT

13. Consider whether evaluations

- identify the location of the property;
- provide a description of the property and its current and projected use;
- provide an estimate of the property's market value in its actual physical condition, use, and zoning designation as of the effective date of the evaluation, with any limiting conditions;
- describe the method(s) the institution used to confirm the property's actual physical condition and the extent to which an inspection was performed;
- describe the analysis that was performed and the supporting information that was used in valuing the property;
- describe the supplemental information that was considered when using an analytical method or technological tool;
- indicate all source(s) of information used in the analysis, as applicable, to value the property; and
- include information on the preparer when an evaluation is performed by a person, such as the name and contact information, and signature (electronic or other legally permissible signature) of the preparer.

VALIDITY OF APPRAISALS AND EVALUATIONS

14. Determine whether the program establishes criteria for assessing whether existing appraisals or evaluations continue to reflect current market values.

- Documentation in the credit files should provide the facts and analysis to support the institution's conclusion that the existing appraisal or evaluation may be used in a subsequent transaction.
- Criteria should be in place for obtaining a new appraisal or evaluation when an existing appraisal or evaluation is no longer valid for a subsequent transaction.

REVIEWING APPRAISALS AND EVALUATIONS

15. Determine whether an institution's policies and procedures for reviewing appraisals and evaluations

- require the receipt and review of appraisal reports and evaluations prior to making the final credit decision;
- address the independence, education, training and qualifications, and role of the reviewer;
- reflect a risk-focused approach for determining the depth of the review;
- establish a process for resolving any deficiencies in appraisals or evaluations; and
- set forth documentation standards for the review and the resolution of noted deficiencies.

THIRD-PARTY ARRANGEMENTS

16. Determine whether the institution has adequate procedures governing the selection, use, and oversight of a third party that performs appraisal management services. Consider the following:

- procedures for governing the due diligence for selecting and entering into an arrangement with a third party;
- internal controls for identifying, monitoring, and managing the risks associated with using a third party arrangement for valuation services;
- documentation of the results of monitoring and periodic assessments of the third party's compliance with applicable regulations and consistency with supervisory guidance;
- timeliness of remedial actions taken when deficiencies are discovered;

- the institution's requirements for the third party to select a competent, qualified, and independent individual or appraiser to perform an evaluation;
- the institution's requirements for the third party to select a state-licensed or state-certified appraiser for a given appraisal; and
- the institution's requirements for the third party to notify the appraiser or the person who performs the evaluation that the institution is the client.

PROGRAM COMPLIANCE

17. Determine whether the institution's appraisal and evaluation policies establish internal controls to promote an effective appraisal and evaluation program. Consider the following:
    - policies and procedures address the need for obtaining current collateral valuation information for monitoring the collateral position over the life of a credit and managing the risk in the real estate credit portfolios;
    - criteria for determining when to obtain a new appraisal or evaluation when there is deterioration in the credit since origination or changes in market conditions;
    - current collateral valuation information to assess collateral risk and facilitate an informed decision on whether to engage in a modification or workout of an existing real estate credit;
    - periodic and independent review of the institution's appraisal and evaluation program and its corresponding internal controls; and
    - procedures to ensure appraisers receive a customary and reasonable fee when the assignment is for a transaction secured by a consumer's principal dwelling, as required by 12 CFR 1026.42.
18. Determine whether management takes action to correct prior deficiencies noted in examination, audit, and loan review reports.
19. Determine whether there is a significant correlation between classified assets and unsubstantiated appraisals and evaluations.

REFERRALS

20. Determine whether the institution has policies, procedures, and internal controls governing the filing of complaints with the appropriate state appraiser regulatory agency or suspicious activity reports (SARs) with the Financial Crimes Enforcement Network (FinCEN) of the Department of the Treasury. Consider the following:
    - Complaints are filed with the appropriate state appraiser regulatory officials when it suspected that a state-certified or state-licensed appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct; and
    - SARs are filed with FinCEN when suspecting fraud or identifying other transactions meeting the SAR filing criteria.

AUTOMATED VALUATION MODELS (COMPLETE IF THE BANK USES AN AUTOMATED VALUATION MODEL)

21. Evaluate the institution's policies, procedures, and internal controls governing the selection, use, and validation of the valuation method or tool used in the development of an evaluation. Determine whether policies and procedures governing the selection of automated valuation models (AVM) include
    - performing an adequate level of due diligence in selecting an AVM vendor and its models, considering how model developers conducted performance testing as well as the sample size used and the geographic level tested (such as county level or zip code);
    - establishing an acceptable minimum performance criteria for a model prior to and independent of the validation process;
    - validating the model(s) during the selection process and documentation of the validation process;
    - evaluating the underlying data used in the model(s), including the data sources and types, frequency of updates, quality control performed on the data, and the sources

of the data in states where public real estate sales data are not disclosed;
- assessing modeling techniques and the inherent strengths and weaknesses of different model types as well as how a model(s) performs for different property types; and
- evaluating the AVM vendor's scoring system and methodology for the model(s), including a determination that the scoring system provides an appropriate indicator of model reliability by property type and geographic location.

22. Evaluate management's implementation and oversight of AVMs. Consider the following:

    - procedures for monitoring the use of an AVM(s), including an ongoing validation process;
    - established AVM performance criteria for accuracy and reliability in a given transaction, lending activity, and geographic location;
    - established criteria for deciding whether a particular valuation method or tool is appropriate for a given transaction or lending activity, considering associated risks, including transaction size and purpose, credit quality, and leverage tolerance (loan-to-value);
    - appropriate controls to ensure that the selected method or tool produce a reliable estimate of market value that supports its decision to engage in a transaction;
    - established criteria to determine when market events or risk factors would preclude the use of a particular method or tool;
    - policies governing the use of multiple methods or tools, if applicable, for valuing the same property or to support a particular lending activity;
    - internal controls to preclude *value shopping* when more than one AVM is used for the same property; and
    - policies and procedures that address the extent to which an inspection or research should be performed to ascertain the property's actual physical condition, and supplemental information should be obtained to assess the effect of market conditions or other factors on the estimate of market value.

SAMPLE TESTING

23. Determine whether the institution's program ensures that appraisals for federally related transactions

    - disclose the purpose and use of the appraisal;
    - provide an opinion of the collateral's market value as defined in the appraisal regulation and clarified in supervisory guidance;
    - provide an effective date for the opinion of market value;
    - provide the sales history of the subject property for the prior three years;
    - provide the valuation approaches (that is cost, income, and sales comparison approaches) that are applicable for the property type and market;
    - include an analysis and reporting of appropriate deductions and discounts when the appraisal provides a market value estimate based on the future demand of the real estate (such as proposed construction, partially leased buildings, nonmarket lease terms, and unsold units in a residential tract development);
    - evaluate and reconcile the valuation approaches into an opinion of market value estimate based on the appraiser's judgment, if multiple approaches were used;
    - explain why a valuation approach is inappropriate and not used in the appraisal;
    - support the assumptions and the value conclusion rendered through adequate documentation and information on market conditions and trends;
    - evaluate key assumptions and potential ramifications to the opinion of market value if these assumptions are not realized;
    - present an opinion of the real property's market value in an appraisal report
    - option that addresses the property's type, market, and risk and type of transaction;
    - provide a level of detail in the appraisal report sufficient to explain and support the appraiser's opinion of market value; and
    - disclose and define other value opinions (such as disposal value of the property or

the value of non-real property), if the institution requests such information.

24. Verify that the

    - institution selects appraisers who are qualified, independent, and appropriately state-licensed or certified; and
    - appraiser's expertise and qualifications demonstrate that the appraiser was competent for the market and property type.

25. Determine the following for appraisals that include the cost approach to value:

    - The values for land and improvements are presented separately,
    - Cost estimates appear to be reasonable,
    - The value allocated to land component of the property is supported by comparable land sales, and
    - Estimates for depreciation appear reasonable and consistent with estimates of effective age of the improvement.

26. Determine the following for appraisals that include the income approach to value:

    - Potential income projections appear reasonable;
    - Adjustments for vacancy and credit loss appear adequate;
    - Operating expenses appear reasonable;
    - Capitalization rates appear reasonable and are supported by market data;
    - Terms and conditions of existing leases reflect market;
    - For an income-producing property subject to existing leases, the value reflects the value of leased fee estate; and
    - For a property to be developed or constructed, assumptions on the construction period, time frame for achieving stabilized occupancy, and expectations for sales absorption rate or lease-up period are reasonable and reflective of market conditions.

27. Determine the following for appraisals that include the sales comparison approach to value:

    - Comparable properties are physically similar;
    - Comparable properties are economically similar;
    - Comparable sales are sufficiently recent (that is, substantial changes in the market have not occurred since the time of the comparable sale); and
    - Adjustments to comparable values are made for any sales concessions, including favorable financing or seller concessions that are not typical in the market.

28. Determine the following for a residential tract development (five or more residential units in the same development):

    - The appraisal includes a market value of the property that reflects deductions and discounts for holding costs, marketing costs, and entrepreneurial profit supported by market data.

Review the bank's internal controls, policies, practices, and procedures for real estate appraisals and evaluations. The bank's system should be accurately and fully documented and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written appraisal and evaluation policies that define the following:
   a. bank management's responsibility for selecting, evaluating, monitoring, and ensuring the independence of the individual who is performing the appraisal or evaluation?
   b. the basis for selecting staff appraisers and engaging fee appraisers for a particular appraisal assignment and for ensuring that the individual is independent of the transaction; possesses the requisite qualifications, expertise, and educational background; demonstrates competency for the market and property type; and has the required state certification or license if applicable?
   c. procedures for when to obtain appraisals and evaluations?
   d. procedures for prohibiting the use of a borrower-ordered or borrower-provided appraisal?
   e. procedures for monitoring collateral risk on a loan and portfolio basis as to when to obtain a new appraisal or new evaluation, including the frequency, triggering events, scope of appraisal work, valuation methods, and report option?
   f. appraisal and evaluation compliance procedures to determine that appraisals and evaluations are reviewed by qualified and adequately trained individuals who are not involved in the loan-production process?
   g. appraisal and evaluation review procedures to ensure that the bank's appraisals and evaluations are consistent with the standards of USPAP and the Board's regulation and guidelines?
   h. appraisal and evaluation review procedures that require the performance of the review prior to the credit decision, resolution of noted deficiencies, and documentation of the review in the credit file, and, if necessary, obtaining a second appraisal or relying on USPAP's Standard Rule 3 in performing a review or performing another evaluation?
   i. an appropriate level of review for appraisals and evaluations ordered by the bank's agents or obtained from another financial services institution?
   j. adequate level of oversight when the bank uses a third party for appraisal management services?
   k. use of analytical methods and technological tools (such as automated valuation models or tax assessment valuations) in the development of evaluations that is appropriate for the risk and type of transaction and property?
   l. internal controls to prevent officers, loan officers, or directors who order or review appraisals and evaluations from having the sole authority for approving the requested loans?
   m. procedures for promoting compliance with the appraisal independence provisions of Regulation Z (Truth in Lending) for open- and closed-end consumer credit transactions secured by a consumer's principal dwelling?
2. Does the board of directors annually review these policies and procedures to ensure that the appraisal and evaluation policies and procedures meet the needs of the bank's real estate lending activity and remains compliant with the Board's regulation and supervisory guidance?

APPRAISALS

*1. Are appraisals in writing, dated, and signed by the appraiser?

*2. Does the appraisal meet the minimum standards of the Board's regulation and USPAP, and contain sufficient information and analysis to support the bank's decision to engage in the transaction? Does the appraisal

a. reflect an appropriate scope of work that will provide for credible results, including the extent to which the property is identified and inspected, the type and extent of data research performed, and the analyses applied to arrive at an opinion of market value?
b. disclose the purpose and use of the appraisal?
c. provide an opinion of the collateral market value as defined in the Board's appraisal regulation and further clarified in supervisory guidance?
d. provide an effective date for the opinion of market value?
e. provide the sales history of the subject property for the prior three years?
f. reflect valuation approaches (that is, cost, income, and sales comparison approaches) that are applicable for the property type and market?
g. include an analysis and reporting of appropriate deductions and discounts when the appraisal provides a market value estimate based on the future demand of the real estate (such as proposed construction, partially leased buildings, nonmarket lease terms, and unsold units in a residential tract development)?
h. evaluate and reconcile the three approaches into an opinion of market value estimate based on the appraiser's judgment?
i. explain why an approach is inappropriate and not used in the appraisal?
j. fully support the assumptions and the value rendered through adequate documentation and information on market conditions and trends?
k. evaluate key assumptions and potential ramifications to the opinion of market value if these assumptions are not realized?
l. present an opinion of the collateral's market value in an appraisal report option that addresses the property type, market, risk, and type of transaction?
m. disclose and define other value opinions (such as disposal value of the property or the value of non-real property), if the bank requests such information?

*3. Are appraisals received before the bank makes its final credit or other credit decision or was the loan granted a conditional approval? When loans have conditional approvals pending receipt of an appraisal, confirm that appraisals are received, reviewed, and accepted for the transaction.

*4. If the bank is depending on an appraisal obtained for another financial services institution as support for its transaction, does the bank have appraisal review procedures to ensure that the appraisal meets the standards of the appraisal regulation, including independence? (These types of transactions would include loan participations, loan purchases, and mortgage-backed securities.)

*5. If an appraisal for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the appraiser is independent, the appraisal complies with the appraisal regulations, and the appraisal is still valid?

APPRAISERS

1. Are appraisers fairly considered for assignments regardless of their membership or lack of membership in a particular appraisal organization?
2. Before the bank selects an appraiser for an assignment, does the bank confirm that the appraiser has the requisite qualifications, education, experience, and competency for both the property type and market to complete the appraisal?
3. If a bank pre-screens appraisers and uses an approved appraiser list, does the bank have procedures for assessing an appraiser's qualifications, selecting an appraiser for a particular assignment, and evaluating the appraiser's work for retention on the list?
4. The following items apply for large, complex, or out-of-area commercial real estate properties:
   a. Are written engagement letters used when ordering appraisals, and are copies of the letters retained or included in the appraisal report?
   b. Does the bank have procedures for resolving deficiencies in appraisals, including determining when such

appraisals should be reviewed by another appraiser (that is, a USPAP Standard Rule 3—Appraisal Review)?

5. Are appraisers independent of the transaction?
   a. Are staff appraisers independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property?
   b. Are fee appraisers engaged directly by the bank or its agent? Has a determination been made that they have no direct or indirect interest, financial or otherwise, in the property or transaction?
   c. Are any appraisers recommended or selected by the borrower (applicant)?
6. If the bank has staff appraisers to perform appraisals or appraisal reviews, does the bank periodically have independent appraisers evaluate their work for quality and confirm that they have the knowledge and competency to perform their work and continue to hold the appropriate state license or certification?
7. If fee appraisers are used by the bank, does the bank investigate their qualifications, experience, education, background, and reputations?
8. Is the status of an appraiser's state certification or license verified with the state appraiser regulatory authority to ensure that the appraiser is in good standing?
9. Does the bank have procedures for filing complaints with the appropriate state appraiser regulatory officials when it suspects the fee appraiser failed to comply with USPAP, applicable state laws, or engaged in other unethical or unprofessional conduct?
10. Are fee appraisers paid the same fee whether or not the loan is granted?
11. Does the bank pay a customary and reasonable fee for appraisal services in the market where the property is located when the appraisal is for an open- and closed-end consumer credit transaction secured by a consumer's principal dwelling as required under Regulation Z?

EVALUATIONS

1. Are the individuals performing evaluations independent of the transaction?

*2. Are the evaluations required to be in writing, dated, and signed?

*3. Does the bank require sufficient information and documentation to support the estimate of value and the individual's analysis?

*4. Are the development and content of the evaluation reflective of transaction risk and appropriate for the property type?

*5. Are the valuation methods used, and does the supporting information in the evaluation provide a reliable estimate of the property's market value as of a stated effective date prior to the credit decision?

*6. If analytical methods or technological tools are used in the development of an evaluation, is the use of the method or tool consistent with safe and sound banking practices?

*7. If an evaluation obtained for one transaction is used for a subsequent transaction, does the bank sufficiently document its determination that the evaluation is still valid?

*8. Are evaluations received before the bank enters into a loan commitment?

*9. Does the bank have evaluation review procedures to ensure that the evaluation meets safe-and-sound banking practices?

*10. If a tax assessment valuation is used in the development of an evaluation, has the bank demonstrated that there is a valid correlation between the tax assessment data and the property's market value?

EVALUATORS

1. Are individuals who perform evaluations competent to complete the assignment?
2. Do the individuals who perform evaluations possess the appropriate collateral valuation training, expertise, and experience relevant to the type of property being valued?
3. Are evaluations prepared by individuals who are independent of the transaction?

MONITORING COLLATERAL VALUES

1. Does the bank have policies to monitor collateral risk on a portfolio and on an individual credit basis?
2. Does the policy address the need to obtain current valuation information for collateral supporting an existing credit that may be modified or considered for a loan workout?
3. Does the criteria for determining when to obtain a new appraisal or new evaluation address deterioration in the credit; material changes in market conditions; and revisions to, or delays in, the project's development and construction?
4. Does the bank sufficiently document and follow its criteria for obtaining reappraisals or reevaluations?

THIRD-PARTY ARRANGEMENTS

1. Did the bank exercise appropriate due diligence in the selection of a third party to perform appraisal management services for the bank?
2. Does the bank have the resources and expertise necessary for performing ongoing oversight of such third party arrangements?
3. Does the bank have the internal controls for identifying, monitoring, and managing the risks associated with the use of the third party?
4. Does the bank adequately document the results of its ongoing monitoring and periodic assessments of the third party's compliance with applicable regulations and with supervisory expectations?
5. Does the bank take timely remedial actions when deficiencies are discovered?
6. Does the bank ensure that the third party selects an appraiser or a person to perform an evaluation who is competent, qualified, independent, and appropriately licensed or certified for a given assignment?
7. Does the bank ensure that the third party conveys to the appraiser or the person who performs the evaluation that the bank is the client?

ANALYTICAL METHODS AND TECHNOLOGICAL TOOLS

1. Does the bank have staff, or if necessary engage a third party, with the requisite expertise and training to manage the selection, use, and validation of an analytical method or technological tool?
2. Does the bank have adequate policies, procedures, and internal controls governing the selection, use, and validation of the valuation method or tool for the development of an evaluation?
3. Does the bank have appropriate policies and procedures governing the selection of automated valuation model (AVM)? For instance, did the bank:
   - Perform the necessary level of due diligence in selecting an AVM vendor and its models, considering how model developers conducted performance testing as well as the sample size used and the geographic level tested (such as county level or zip code).
   - Establish acceptable minimum performance criteria for a model prior to, and independent of, the validation process.
   - Perform validation of the model(s) during the selection process and document the validation process.
   - Evaluate underlying data used in the model(s), including the data sources and types, frequency of updates, quality control performed on the data, and the sources of the data in states where public real estate sales data are not disclosed.
   - Assess modeling techniques and the inherent strengths and weaknesses of different model types as well as how a model(s) performs for different property types.
   - Evaluate the AVM vendor's scoring system and methodology for the model(s).
   - Determine whether the scoring system provides an appropriate indicator of model reliability by property types and geographic locations.
4. Does the bank have procedures for monitoring the use of an AVM(s), including an ongoing validation process?
5. Does the bank maintain AVM performance criteria for accuracy and reliability in a given transaction, lending activity, and geographic location?

6. Has the bank established a criteria for determining whether a particular valuation method or tool is appropriate for a given transaction or lending activity, considering associated risks, including transaction size and purpose, credit quality, and leverage tolerance (loan-to-value)?
7. Does the criteria consider when market events or risk factors would preclude the use of a particular method or tool?
8. Does the bank have internal controls to preclude "value shopping" when more than one AVM is used for the same property?
9. Do the bank's policies include standards governing the use of multiple methods or tools, if applicable, for valuing the same property or to support a particular lending activity?
10. Does the bank have appropriate controls to ensure that the selected method or tool produces a reliable estimate of market value that supports the bank's decision to engage in a transaction?
11. Do the bank's policies and procedures adequately address the extent to which
    - An inspection or research should be performed to ascertain the property's actual physical condition, and
    - Supplemental information should be obtained to assess the effect of market conditions or other factors on the estimate of market value.

Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

Effective date October 2013

Section 2103.1

This interagency supervisory guidance was developed to reinforce sound risk-management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets. The guidance, Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk-Management Practices (the guidance), was issued on December 6, 2006 (effective on December 12, 2006).[1] However, institutions needing to improve their risk-management processes may have been provided the opportunity for some flexibility on the time frame for complying with the guidance. This time frame will be commensurate with the level and nature of CRE concentration risk, the quality of the institution's existing risk-management practices, and its levels of capital. (See 71 *Fed. Reg.* 74,580 [December 12, 2006], the Federal Reserve Board's press release dated December 6, 2006, and SR-07-01 and its attachments.)

SCOPE OF THE CRE CONCENTRATION GUIDANCE

The guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. For the purposes of this guidance, CRE loans include those loans with risk profiles sensitive to the condition of the general CRE market (for example, market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans are land development and construction loans (including one- to four-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third-party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to real estate investment trusts and unsecured loans to developers also should be considered CRE loans for purposes of this guidance if their performance is closely linked to performance of the CRE markets. The scope of the guidance does *not* include loans secured by owner-occupied nonfarm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property. Rather than defining a CRE concentration, the guidance's "Supervisory Oversight" section describes the criteria that the Federal Reserve will use as high-level indicators to identify banks potentially exposed to CRE concentration risk.

1. The guidance was jointly adopted by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

CRE CONCENTRATION ASSESSMENTS

Banks that are actively involved in CRE lending should perform ongoing risk assessments to identify CRE concentrations. The risk assessment should identify potential concentrations by stratifying the CRE portfolio into segments that have common risk characteristics or sensitivities to economic, financial, or business developments. A bank's CRE portfolio stratification should be reasonable and supportable. The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.

The Federal Reserve recognizes that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary by bank depending on the portfolio risk characteristics, the quality of risk-management processes, and capital levels. Therefore, the guidance does not establish a CRE concentration limit that applies to all banks. Rather, banks are encouraged to identify and monitor credit concentrations and to establish internal concentration limits, and all concentrations should be reported to senior management and the board of directors on a periodic basis. Depending on the results of the risk assessment, the bank may need to enhance its risk-management systems.

CRE RISK MANAGEMENT

The sophistication of a bank's CRE risk-management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the bank. Banks should address the following key elements in establishing a risk-management framework that effectively identifies, monitors, and controls CRE concentration risk:

1. board and management oversight
2. portfolio management
3. management information systems
4. market analysis
5. credit underwriting standards
6. portfolio stress testing and sensitivity analysis
7. credit risk review function

Board and Management Oversight of CRE Concentration Risk

A bank's board of directors has ultimate responsibility for the level of risk assumed by the bank. If the bank has significant CRE concentration risk, its strategic plan should address the rationale for its CRE levels in relation to its overall growth objectives, financial targets, and capital plan. In addition, the Federal Reserve's real estate lending regulations require that each bank adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, including CRE loans. Therefore, the board of directors or a designated committee thereof should—

1. establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the bank, including any specific commitments to particular borrowers or property types, such as multifamily housing;
2. ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies;
3. review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions in which the bank lends; and
4. periodically review and approve CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) to conform to any changes in the bank's strategies and to respond to changes in market conditions.

CRE Portfolio Management

Banks with CRE concentrations should manage not only the risk of individual loans but also portfolio risk. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by cyclical changes in the CRE market can expose a bank to an unacceptable level of risk if not properly managed. Management regularly should evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines and concentration limits that control the bank's overall risk exposure.

Management should develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess periodically the marketability of the portfolio. This should include an evaluation of the bank's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

CRE Management Information Systems

A strong management information system (MIS) is key to effective portfolio management. The sophistication of the MIS will necessarily vary with the size and complexity of the CRE portfolio and level and nature of concentration risk. The MIS should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk. This includes meaningful information on CRE portfolio characteristics that is relevant to the bank's lending strategy, underwriting standards, and risk tolerances. A bank should assess periodically the adequacy of the MIS in light of growth in CRE loans and changes in the CRE portfolio's size, risk profile, and complexity.

Banks are encouraged to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating. Other useful stratifications may include loan structure (for example, fixed-rate or adjustable), loan purpose (for example, construction, short-term, or permanent), loan-to-value (LTV) limits, debt service coverage, policy exceptions on newly underwritten credit facilities, and affiliated loans (for example, loans to tenants). A bank should also be able to identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives.

Management reporting should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations. In addition, management reporting should include a well-defined process through which management reviews and evaluates concentration and risk-management reports, as well as special ad hoc analyses in response to potential market events that could affect the CRE loan portfolio.

Market Analysis

Market analysis should provide the bank's management and board of directors with information to assess whether its CRE lending strategy and policies continue to be appropriate in light of changes in CRE market conditions. A bank should perform periodic market analyses for the various property types and geographic markets represented in its portfolio.

Market analysis is particularly important as a bank considers decisions about entering new markets, pursuing new lending activities, or expanding in existing markets. Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. The sophistication of a bank's analysis will vary by its market share and exposure, as well as the availability of market data. While a bank operating in nonmetropolitan markets may have access to fewer sources of detailed market data than a bank operating in large, metropolitan markets, a bank should be able to demonstrate that it has an understanding of the economic and business factors influencing its lending markets.

Credit Underwriting Standards

A bank's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate all relevant credit factors. When a bank has a CRE concentration, the establishment of sound lending policies becomes even more critical. In establishing its policies, a bank should consider both internal and external factors, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. Consistent with the Federal Reserve's real estate lending guidelines, CRE lending policies should address the following underwriting standards:

1. maximum loan amount by type of property
2. loan terms
3. pricing structures
4. collateral valuation[2]
5. LTV limits by property type
6. requirements for feasibility studies and sensitivity analysis or stress testing
7. minimum requirements for initial investment and maintenance of hard equity by the borrower
8. minimum standards for borrower net worth, property cash flow, and debt service coverage for the property

A bank's lending policies should permit exceptions to underwriting standards only on a limited basis. When a bank does permit an exception, it should document how the transaction does not conform to the bank's policy or underwriting standards, obtain appropriate management approvals, and provide reports to the board of directors or designated committee detailing the number, nature, justifications, and trends for exceptions. Exceptions to both the bank's internal lending standards and the Fed-

2. Refer to the Federal Reserve's appraisal regulations: 12 CFR 208 subpart E and 12 CFR 225, subpart G.

eral Reserve's supervisory LTV limits[3] should be monitored and reported on a regular basis. Further, banks would analyze trends in exceptions to ensure that risk remains within the bank's established risk tolerance limits.

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations as appropriate. In addition, for development and construction loans, the bank should have policies and procedures governing loan disbursements to ensure that the bank's minimum borrower equity requirements are maintained throughout the development and construction periods. Prudent controls should include an inspection process, documentation on construction progress, tracking pre-sold units, pre-leasing activity, and exception monitoring and reporting.

CRE Portfolio Stress Testing and Sensitivity Analysis

A bank with CRE concentrations should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Further, a bank should consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of the CRE loan portfolio. For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.

Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. The analysis should focus on the more vulnerable segments of a bank's CRE portfolio, taking into consideration the prevailing market environment and the bank's business strategy.

3. The Interagency Guidelines for Real Estate Lending state that loans exceeding the supervisory LTV guidelines should be recorded in the bank's records and reported to the board at least quarterly.

Credit Risk Review Function

A strong credit risk review function is critical for a bank's self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the bank's credit risk review function to assess credit quality and, ultimately, to identify problem loans. Risk ratings should be risk sensitive, objective, and appropriate for the types of CRE loans underwritten by the bank. Further, risk ratings should be reviewed regularly for appropriateness.

SUPERVISORY OVERSIGHT OF CRE CONCENTRATION RISK

As part of its ongoing supervisory monitoring processes, the Federal Reserve will use certain criteria to identify banks that are potentially exposed to significant CRE concentration risk. A bank that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

1. total reported loans for construction, land development, and other land[4] represent 100 percent or more of the bank's total capital[5] or
2. total commercial real estate loans as defined in this guidance[6] represent 300 percent or

4. For commercial banks as reported in the Call Report FFIEC 031 and 041, schedule RC-C, item 1a(1) and 1a(2).

5. For purposes of this guidance, the term *total capital* means the total risk-based capital as reported for commercial banks in the Call Report FFIEC 031 and 041 schedule RC-R—Regulatory Capital, line 21.

6. For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C, items 1a(1), 1a(2), 1d, 1e(2), and memorandum item 3. Effective with the March 31, 2008, Call Report revision, item 1a on Schedule RC-C was split into two components. Item 1a(1) reports 1–4 family residential construction loans, and item 1a(2) reports other construction loans and all land development and other land loans. Both items 1a(1) and 1a(2) are used to calculate total reported loans for construction, land development, and other land. Also effective with the March 31, 2008, Call Report, item 1e on Schedule RC-C was split into two components. Item 1e(1) reports the amount of owner-occupied CRE loans, and item 1e(2) reports the amount of non-owner-occupied CRE loans. The amendment enables the exclusion of owner-occupied CRE loans in the total CRE loan ratio in accordance with the scope of the 2006 CRE Guidance. The supervisory

more of the bank's total capital, and the outstanding balance of the bank's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

The Federal Reserve will use the criteria as a preliminary step to identify banks that may have CRE concentration risk. Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on a bank's lending activity but rather serve as high-level indicators to identify banks potentially exposed to CRE concentration risk. Nor do the criteria constitute a "safe harbor" for banks if other risk indicators are present, regardless of their measurements under (1) and (2).

Evaluation of CRE Concentrations

The effectiveness of a bank's risk-management practices will be a key component of the supervisory evaluation of the bank's CRE concentrations. Examiners will engage in a dialogue with the bank's management to assess CRE exposure levels and risk-management practices. Banks that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

In evaluating CRE concentrations, the Federal Reserve will consider the bank's own analysis of its CRE portfolio, including consideration of factors such as—

1. portfolio diversification across property types
2. geographic dispersion of CRE loans
3. underwriting standards
4. level of pre-sold units or other types of take-out commitments on construction loans
5. portfolio liquidity (ability to sell or securitize exposures on the secondary market)

While consideration of these factors should not change the method of identifying a credit concentration, these factors may mitigate the risk posed by the concentration.

Assessment of Capital Adequacy for CRE Concentration Risk

The Federal Reserve's existing capital adequacy guidelines note that a bank should hold capital commensurate with the level and nature of the risks to which it is exposed. Accordingly, banks with CRE concentrations are reminded that their capital levels should be commensurate with the risk profile of their CRE portfolios. In assessing the adequacy of a bank's capital, the Federal Reserve will consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk-management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk. A bank with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate to the level and nature of its CRE concentration risk.

screening criteria are not intended to limit an institution's CRE lending activity. The intent of these indicators is to encourage a dialogue between the supervisory staff and an institution's management about the level and nature of CRE concentration risk.

Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices

Examination Objectives

Effective date October 2007

Section 2103.2

When a bank has significant commercial real estate (CRE) credit concentrations, the inspection objectives are as follows:

1. To determine if the bank's risk-management practices and capital levels are commensurate with the level and nature of its CRE concentration risk.
2. To ascertain if the bank performs ongoing risk assessments to identify its CRE concentrations.
3. To evaluate whether the bank's CRE risk-management processes are appropriate for the size of its CRE loan portfolio, as well as for the level and nature of its concentrations and their associated risks to the bank.
   a. To determine whether the bank's strategic plan addresses the rationale for its CRE credit concentration levels in relation to its overall growth objectives, financial targets, and capital plan.
   b. To evaluate whether the bank manages not only the risk of individual loans but also its loan portfolio risks.
   c. To find out if the bank's management information system provides management with sufficient information that can be used to identify, measure, and manage the bank's CRE concentration risk.
   d. To verify whether the bank's market analyses provide the bank's management and board of directors with sufficient information to assess whether the bank's CRE lending strategy and policies continue to be appropriate in light of its changing CRE market conditions.
4. To determine if the bank's CRE lending policies reflect the level of credit risk that is acceptable to its board of directors.
   a. To evaluate whether the lending policies provide clear and measurable underwriting standards.
   b. To assess whether the bank's lending policies enable the bank's lending staff to evaluate all relevant credit factors.
5. To find out if the bank performs portfolio-level stress tests or sensitivity analyses in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital.
6. To determine if the bank has a strong credit-review function that includes a self-assessment of its emerging credit and other risks.

RISK MANAGEMENT

Board and Senior Management Oversight

1. Determine if the board of directors or its designated committee has—
   a. established policy guidelines and approved an overall commercial real estate (CRE) lending strategy on the level and nature of the bank's CRE exposures, including any specific commitments to particular borrowers or property types, such as multifamily housing;
   b. ensured that management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies;
   c. reviewed information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including a review of reports that describe changes in the CRE market conditions in which the bank lends; and
   d. periodically reviewed and approved CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) to ensure they conform to any changes in the bank's strategies and respond to changes in market conditions.

Supervisory Oversight

2. Determine if the bank is (or is potentially) exposed to significant CRE credit concentration risk.
3. If the bank has experienced rapid growth in CRE lending or has notable exposure to a specific type of CRE, or if the bank is approaching or exceeds one or both of the following criteria, perform a preliminary analysis of the bank's CRE concentration risk:
   a. Total loans for construction, land development, and other land represent 100 percent or more of the bank's total capital.
   b. Total CRE loans represent 300 percent or more of the bank's total capital, and the outstanding balance of the bank's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Portfolio Management

4. Ascertain whether the bank manages not only the risk from individual loans but also portfolio risk. Find out if management—
   a. regularly (1) evaluates the degree of correlation between related real estate sectors and (2) establishes internal lending guidelines and concentration limits that control the bank's overall risk exposure; and
   b. develops appropriate strategies for managing CRE concentration levels, including the development of a contingency plan to reduce or mitigate concentrations during adverse CRE market conditions (such a plan may include strategies involving loan participations, whole loan sales, and securitizations).
      - Find out if the bank's contingency plan includes selling or securitizing CRE loans.
      - Ascertain if management periodically assesses the marketability of the CRE portfolio and evaluates the bank's ability to access the secondary market.
      - Verify whether the bank compares its underwriting standards with those that exist in the secondary market.

Management Information Systems

5. Evaluate whether management information systems (MIS) provide sufficient information to identify, measure, monitor, and manage CRE concentration risk (MIS should include information on CRE portfolio characteristics that are consistent with and relevant to the bank's lending strategy, underwriting standards, and risk tolerances).
6. Verify that management reporting is timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations.

Market Analysis

7. Determine if management reporting includes a well-defined process through which management reviews and evaluates concentration and risk-management reports, as well as special ad hoc analyses that are prepared in response to potential market events that could affect the CRE loan portfolio.
8. Find out if the bank's market analysis provides management and the board of directors with sufficient information to assess (1) the bank's CRE lending strategy and policies and (2) whether they continue to be appropriate in light of changes in CRE market conditions.

Credit-Underwriting Standards

9. Determine if CRE lending policies include the following underwriting standards:
   a. maximum loan amount by type of property
   b. loan terms
   c. pricing structures
   d. collateral valuation
   e. loan-to-value (LTV) limits by property type
   f. requirements for feasibility studies and sensitivity analyses or stress testing
   g. minimum requirements for initial investment and maintenance of hard equity by the borrower
   h. minimum standards for borrower net worth, property cash flow, and debt-service coverage for the property
10. Review the bank's permitted exceptions to its underwriting standards. Ascertain if the exceptions—
    a. have been granted on a limited basis only; and
    b. are supported by documentation and reports to management and the board of directors or a designated committee. The documentation and reports should indicate—
       - how the transactions did not conform to the bank's policy or underwriting standards;
       - whether appropriate management approvals were obtained; and
       - the details of the number and nature of and the justifications and trends for the exceptions.
11. Verify that exceptions to both the bank's internal lending standards and the Federal Reserve's supervisory LTV limits are monitored and reported on a regular basis.
12. Find out if the bank analyzes trends in its CRE lending exceptions in order to ensure that credit-underwriting risk remains within its established risk-tolerance limits.
13. Evaluate whether the bank's credit analyses reflect both the borrowers' overall creditworthiness and project-specific considerations, as appropriate.
14. For the bank's development and construction loans, determine if—
    a. the bank has policies and procedures governing loan disbursements in order to ensure that the bank's requirements for minimum borrower equity are maintained throughout the development and construction periods; and
    b. prudent controls, including the following, are in place:
       - an inspection process
       - documentation of construction progress
       - tracking of pre-sold units
       - pre-leasing activity
       - exception monitoring and reporting

Portfolio Stress Testing and Sensitivity Analysis

15. When the bank has CRE concentrations, determine if it performs portfolio-level stress tests or sensitivity analyses in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital.
    a. Ascertain if the bank considers the sensitivity of portfolio segments with common risk characteristics to potential market conditions.
    b. Determine whether the sophistication of the bank's stress-testing practices and sensitivity analyses are consistent with the size, complexity, and risk characteristics of its CRE loan portfolio.
    c. Evaluate whether the bank's sensitivity analyses focus on the more vulnerable segments of its CRE portfolio, considering its prevailing market environment and business strategy.

Credit-Review Function

16. Find out if the bank has a credit-review function, and if it is supported by a credit-risk rating system that is used to assess credit quality and identify problem loans.
17. Determine if (1) the bank's risk ratings are risk-sensitive, objective, and appropriate for the types of CRE loans underwritten and (2) the risk ratings are regularly reviewed.

EVALUATION OF CRE CONCENTRATIONS

1. Engage in a dialogue with bank management in order to assess the bank's CRE exposure levels and risk-management practices. If the bank has experienced recent, significant growth in CRE lending, perform an expanded review of the bank's risk in CRE concentrations, including a review of the bank's analysis of its CRE concentrations. Consider factors such as—
   a. portfolio diversification across property types
   b. the geographic dispersion of CRE loans
   c. underwriting standards
   d. the level of pre-sold units or other types of take-out commitments on construction loans
   e. portfolio liquidity (the ability to sell or securitize exposures on the secondary market)

Assessment of Capital Adequacy

2. Evaluate whether the bank's holds capital commensurate with the risk profile of its CRE portfolios. Consider the level and nature of inherent risk in the bank's CRE portfolio, as well as management expertise, historical performance, underwriting standards, risk-management practices, market conditions, and any loan-loss reserves allocated for CRE concentration risk.
3. If a bank has inadequate capital to serve as a buffer against unexpected losses from its CRE concentration, reach agreement with the bank's senior management and board of directors on the development of a plan to reduce the bank's CRE concentrations or to maintain capital that is appropriate and commensurate with the level and nature of the bank's CRE concentration risk.

CRE CONCENTRATION ASSESSMENTS

1. Are ongoing risk assessments performed to identify commercial real estate (CRE) concentrations?
2. Are CRE concentration limits established and monitored?
3. Is the CRE portfolio stratified into reasonable and supportable segments that have common risk characteristics or sensitivities to economic, financial, or business developments?
4. Are all CRE concentrations reported to senior management and the board of directors on a periodic basis?

RISK MANAGEMENT

1. Has a risk-management framework been established that effectively identifies, monitors, and controls CRE concentration risk? If such a framework has been established, does it address—
   a. board and management oversight?
   b. portfolio management?
   c. management information systems?
   d. market analysis?
   e. credit-underwriting standards?
   f. portfolio stress testing and sensitivity analysis?
   g. the credit-risk review function?

Board and Management Oversight

2. If the bank has significant CRE concentration risk, does it have a strategic plan that addresses the rationale for its CRE concentration levels in relation to the bank's overall growth objectives, financial targets, and capital plan?
3. Has the board of directors or its designated committee—
   a. established policy guidelines and approved an overall CRE lending strategy for the level and nature of CRE exposures, including any specific commitments to particular borrowers or property types, such as multifamily housing?
   b. ensured that the bank's management implements procedures and controls to effectively adhere to and monitor compliance with the bank's lending policies and strategies?
   c. reviewed information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including a review of reports that describe changes in the conditions of the CRE market in which the bank lends?
   d. periodically reviewed and approved CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) in order to conform to any changes in the bank's strategies and respond to changes in market conditions?

Portfolio Management

4. Does the bank's management regularly perform an analysis of its CRE portfolio, considering factors such as—
   a. portfolio diversification across property types?
   b. the geographic dispersion of CRE loans?
   c. underwriting standards?
   d. the level of pre-sold units or other types of take-out commitments on construction loans?
   e. portfolio liquidity (the ability to sell or securitize exposures on the secondary market)?
5. Has the bank's board of directors and senior management—
   a. (1) regularly evaluated the degree of correlation between related real estate sectors and (2) established internal lending guidelines?
   b. established internal lending guidelines and concentration limits in order to control the bank's overall risk exposure?
   c. developed appropriate strategies to manage CRE concentration levels?
6. Has the bank's management developed a

contingency plan to reduce or mitigate CRE loan concentrations during adverse market conditions? If the bank's contingency plan includes selling or securitizing CRE loans, has management periodically assessed the marketability of the portfolio?

Management Information System

7. Does the bank's management information system (MIS) provide sufficient information to identify, monitor, and manage CRE concentration risk?
8. Is the bank's CRE portfolio stratified by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating?
9. Does the bank's MIS identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives?
10. Are the bank's management reports timely and in a format that clearly indicates changes in the portfolio's risk profile?
11. Does the bank's management reporting include a well-defined process whereby management reviews and evaluates CRE concentrations, risk-management reports, and special ad hoc analyses prepared in response to potential market events that could affect the concentration risk in the bank's CRE portfolio?

Credit-Underwriting Standards

12. Are underwriting standards clear and measurable, and do they enable the bank's lending staff to evaluate relevant credit factors?
13. Do the bank's CRE lending policies address the following underwriting standards—
    a. maximum loan amount by type of property?
    b. loan terms?
    c. pricing structures?
    d. collateral valuation?
    e. loan-to-value (LTV) limits by property type?
    f. requirements for feasibility studies and sensitivity analyses or stress testing?
    g. minimum requirements for initial investment and maintenance of hard equity by the borrower?
    h. minimum standards for borrower net worth, property cash flow, and debt-service coverage for the property?
14. Do the bank's lending policies permit exceptions to its underwriting standards for CRE concentrations on a limited basis only?
15. Are permitted exceptions documented; that is, do the documented exceptions describe how the loan transaction does not conform to the bank's lending policy or underwriting standards?
16. Does management analyze trends in exceptions to ensure that the bank's CRE concentration risk remains within established risk-tolerance limits?
17. Does the bank have policies and procedures governing loan disbursements in order to ensure that its minimum requirements for borrower equity are maintained throughout development and construction periods?
18. Do the bank's internal controls consist of an inspection process, documentation on construction progress, tracking of pre-sold units, tracking of pre-leasing activity, and exception monitoring and reporting?

Portfolio Stress Testing and Sensitivity Analysis

19. Are portfolio stress tests or sensitivity analyses performed in order to quantify the impact of changing economic conditions on asset quality, earnings, and capital?
20. If performed, are portfolio stress tests or sensitivity analyses required to focus on the more vulnerable segments of the bank's CRE portfolio? Do they take into consideration the prevailing market environment and the bank's business strategy?

Credit-Review Function

21. Does the bank have an effective, accurate, and timely risk-rating system that supports its credit-review function?
22. Are credit-risk ratings reviewed regularly for appropriateness?

INTRODUCTION

Floor-plan lending is a form of credit extended to a dealer of consumer or commercial goods to finance inventory that is subsequently sold to the public. The facility is generally in the form of a revolving line of credit used to purchase inventory, which usually is comprised of durable goods, and serves as the bank's collateral. Banks often provide floor-plan loans to dealers of items that are sold under a sales-finance type of contract, such as automobiles, trucks, boats, and mobile homes.

As each unit of inventory is sold, the borrower/dealer repays the loan advancements. The basic risks inherent to inventory financing are the high loan-to-value ratio (that is the outstanding loan amount to the value of the collateral) and the potential for rapid depreciation in value of the collateral. When inventory does not sell as expected, the borrower/dealer may be required by the loan agreement to repay the debt from other cash sources. For this reason, the exposure to loss is generally higher for floor-plan lending (for example, a floor-plan loan to automobile dealer) than other types of inventory financing. See "Collateral" later in this section for more information.

In some cases, the bank providing the floor-plan loan may also provide the financing to the consumer purchasing the item, referred to as dealer financing. Under dealer financing, the dealer sells the goods to the consumer with financing and the bank provides the financing for the purchase, resulting in the bank financing both the dealer floor-plan and the consumer purchase. As a result, a bank expands its borrower base beyond the floor-plan loan by providing financing to the consumer who purchases an inventory item. See "Indirect Lending" later in this section for more information.

BANK/DEALER RELATIONSHIP

Two important facets of the bank's relationship with a dealer are (1) the quality of the consumer financing contracts and (2) the nature or extent of the overall banking relationship with the dealer, which may include deposit products, cash management services, and trust activities. The income derived from a floor-plan loan may not be sufficient for the bank to justify the credit risk assumed as a result of the floor-plan loan alone. However, income derived from the overall banking relationship with the dealer may support the credit risk associated with the floor-plan loan.

Examiners should review the flow of funds into and out of the dealer's account. The flow of funds may indicate that inventory has been sold without debt reduction; that the dealer is incurring abnormal expenses; or that unreported diversification, expansion, or other financial activity has occurred, warranting a reassessment of the credit arrangement. Examiners should also pay particular attention to persistent overdrawn balances of the dealer, as this could be an indicator of financial difficulties.

LOAN POLICY

In general, the bank's loan policy should address its floor-plan lending program. Examiners should determine whether the bank has established prudent standards to control the credit and operational risks associated with floor-plan lending. Refer to the examination procedures for more information on loan policy expectations.

COLLATERAL

The primary collateral for a floor-plan loan is the inventory financed by the dealer. As with all inventory financing, collateral value is fundamental to assessing the secondary source of payment as protection to the bank. In assessing the bank's management over the inventory, examiners should consider whether the bank (1) determines the value of collateral at the time the loan is being underwritten; (2) periodically inspects the collateral by reviewing the condition of the collateral, performing physical counts, and reconciling inventory to bank records; and (3) ensures timely payments by the dealer to the bank when inventory is sold. When the pace of sales is slower than anticipated when the loan was originated, the collateral remains in inventory longer, resulting in "dated" or "stale" inventory. In these cases, the bank's loan agreement may require the dealer to make additional payments (known as "curtailment") to reflect any depreciation in the value of the dated inventory. In addition, the loan agreement may address periodic curtailment payments that are expected to commence on a set schedule and at a predetermined percentage of the amount financed. Curtailment payments are usually not required until the end of one model year and the start of the new model year. The introduction of new models may reduce the value of dealer's existing inventory and, in turn, the value of the bank's collateral.

SECURITY INTEREST

A new floor-plan loan agreement generally involves three parties: (1) the supplier of the goods being sold to the dealer, (2) the dealer (the borrower), and (3) the bank (the floor-plan lender). When a dealer enters into a financing arrangement with a bank, the dealer executes a master loan agreement that sets forth the basic conditions of the relationship among the three parties. This agreement grants the bank a continuing security interest in the dealer's inventory, receipts, and accounts receivable. The security interest to floor-plan inventory is evidenced by a trust receipt. A bank prepares a trust receipt document for the dealer receiving the floor-plan financing to execute when inventory is received. The trust receipt provides evidence that the dealer possesses the inventory being financed. This document establishes the bank's rights to the inventory collateral and the proceeds from the sale of the inventory and refers to other loan documents that set forth the rights of the bank.

Generally, banks create trust receipts in two ways. First, the bank may enter into a drafting agreement with the manufacturer, which is similar to a letter of credit. In this situation, the bank agrees to pay the manufacturer's drafting agreements when shipments of merchandise are sent to the dealer. The bank pays the manufacturer (that is, pays the draft) when the dealer receives the merchandise or, if the manufacturer permits, after a grace period. This grace period allows the dealer to prepare the inventory for sale. The drafting agreement usually provides limits on the number of units, the per-unit cost, and the aggregate cost that can be shipped at any one time. Drafting agreements are frequently used in conjunction with repurchase agreements when the manufacturer agrees to repurchase inventory from the dealer when inventory items remain unsold after a specified period of time. The inventory and ownership documents (that is, title to the collateral) remain with the dealer until inventory items are sold and are evidenced by a trust receipt. A bank's periodic physical inspection of the collateral should confirm that the bank has perfected its security interest in the collateral and that the dealer/borrower has not pledged the bank's collateral to another lender.

A second way a bank creates a trust receipt is when merchandise is shipped under an invoice system. The dealer receives the inventory accompanied by the manufacturer's invoice and title to the collateral, where appropriate. The dealer then presents the documents to the bank and the bank pays the manufacturer, attaching duplicates of the documents to a trust receipt that is signed by the borrower. Depending on the type of inventory and the dealer, the title to the collateral may remain with the bank until the collateral is sold by the dealer and the dealer makes a loan repayment to the bank. For example, used car inventories are usually financed with trust receipts listing each item of the inventory and a specific loan amount for each item.

A floor-plan facility often includes an agreement from the manufacturer to repurchase unsold inventory within specified time limits. The bank and manufacturer could execute other agreements on matters, such as loss sharing and recourse against the dealer. The method of perfecting a security interest varies from state to state, which may diverge from the Uniform Commercial Code (UCC). For information on UCC requirements regarding secured transactions, refer to section 2080.1, "Commercial and Industrial Loans."

INVENTORY INSPECTIONS

As with all inventory financing, collateral control and valuation are critical. Examiners should determine whether the bank's scope and frequency of collateral inspections are adequate and align with the floor-plan loan agreement. Examiners should review the bank's scope of the collateral inspection, and determine whether inspection is sufficiently comprehensive to detect irregularities and to support the value of the collateral. Floor-plan collateral inspections may be completed by internal bank staff, or delegated to a third-party inspector. When inspections are delegated to a third party, examiners should consider whether bank management has included the vendor in its approved vendor risk management program. For more information, see SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management."

Where practical, inspection duties should be rotated among the bank's staff or third-party providers. Inspectors can verify the floor-planned inventory by comparing product serial numbers, manufacturers' certificates of origin, or title information against bank collateral records. In addition, inspection reports typically reflect whether the floor-planned inventory is available for sale. See "Control Systems" later in this section for additional information.

DEALER FINANCIAL ANALYSIS

Many dealers have minimal liquidity and capital relative to total debt, therefore, examiners may consider the frequency with which the bank obtains and reviews the dealer's financial statements. Typically, dealer financial statements are reviewed at least annually, or more frequently as needed. The bank may request that the dealer provide copies of the periodic financial reports that the dealer sends to its franchiser. In addition, dealership financial statements prepared by the manufacturer may contain summary and detailed information on the dealer's financial condition and performance. In analyzing the data, the bank may review the number of units sold, the profitability of the sales, and compare the number of units sold with the number of units financed to determine whether inventory levels are reasonable.

A dealer's primary asset is the inventory. Therefore, the risk to the bank is that floor-plan loan exceeds the value of the dealer's inventory. The dealer's financial statement should show an inventory figure at least equal to the outstanding balance of related floor-plan loan. Unless the difference is represented by short-term sales receivables, including contracts in transit, a floor-plan liability that is greater than the amount of inventory is an indication that the dealer has sold inventory and has not made the appropriate loan payment. To assess credit quality of a bank's floor-plan loan, examiners should closely evaluate the level of the dealer's floor-plan debt relative to value of the inventory.

A bank that relies on sponsor or manufacturer support as a source of repayment should establish guidelines for evaluating the qualifications of the sponsor and the manufacturer and should implement a process to monitor their financial conditions regularly. A bank may consider sponsor and manufacturer supports in assigning a risk rating when the bank can document the history of demonstrated supports and their economic incentives, capacities, and stated intent to continue to support the transaction.

IDENTIFYING PROBLEMS

Missing inventory, reportedly sold and unpaid, is usually verified to related contracts-in-process. Examiners should ascertain whether the time to collect on contracts-in-process is reasonable and conforms to the floor-plan agreement. Floor-planned inventory sold and not in the process of payment is termed "sold out of trust" (banks may use the acronym SOT) and represents a breach of trust by the dealer—and a significant exposure to the bank as the floor-planned inventory sold and not in the process of payment is now an unsecured credit. If inventory has been SOT, the bank generally will require the dealer to repay immediately he loan associated with the SOT inventory. Inventory that has been SOT may indicate a potential fraud issue, and the bank may need to file a suspicious activity report (SAR). Examiners should request and review information (e.g., the bank's internal management reports and investigations) related to SOT situations that have occurred and determine whether management is dealing with such situations appropriately.

Recurring SOT positions that are not cleared by the dealer in a reasonable time should be a red flag to the bank to take further action. If a dealer is deliberately withholding funds or diverting funds received from the sale of pledged inventory, the bank management will generally meet with the borrower to discuss this situation and, if appropriate, consider appropriate action to minimize loss exposure. Bank lending staff should be aware that some large dealerships simultaneously finance inventory with multiple lenders based on the incentives offered to them. In underwriting and approving a floor-plan loan, a bank should consider whether or not the bank is financing only part of the dealer's total floor-plan debt that originates from one particular manufacturer or distributor. When assessing borrower quality, examiners should consider interest and curtailment payment delinquencies; extensions of maturities beyond reasonable expectations; slow turnover of inventory; and lack of financial statements from the borrower.

INDIRECT LENDING

Indirect lending involves a bank funding consumer purchases from the dealer. Indirect lending typically takes one of two forms: (1) the dealer may originate loans to customers, which the bank purchases ("dealer paper") or (2) the dealer may forward the loan application to the bank, which then originates the loan to the consumer.

Banks purchase loans from dealers through two basic arrangements: recourse and nonrecourse. With recourse agreements, the bank purchases the contract from the dealer and may exercise recourse by requiring the dealer to repurchase the contract or pay deficiencies in the event of nonperformance by the consumer. Conversely, with nonrecourse purchases, the bank assumes full responsibility for underwriting the loan and carries all the risk, even though the dealer handles the loan application and customer contact.

Examiners should determine whether banks engaged in indirect lending have established appropriate policies to govern such activities. The approval of a dealer for indirect lending is an expression of willingness to accept those loans that meet the bank's underwriting standards, and that there is no obligation on the part of the bank to buy these loans.

Examiners should review the bank's policy for indirect lending and assess whether the policy conforms to the bank's underwriting standards, regardless of whether the bank or the dealer underwrites the loan. See section 2130.1, "Consumer Credit" for additional details on indirect lending.

CONTROL SYSTEMS

Management Information Systems

Examiners should assess the accuracy and comprehensiveness of the bank's management information systems (MIS) to identify, measure, monitor, and control risks associated with floor-plan lending. Effective MIS monitors include inventory shipments, loan repayment status, inventory levels, inventory conditions, turnover rates, loan collection efforts, manufacturer/dealer recourse, loan curtailments, and credit concentrations within the floor-plan lending portfolio. Other portfolio management reports may typically include a summary risk rating profile of the dealers financed, composition of new versus used inventory, over-line accounts, past-due floor-plan inspections, and the level of exceptions to policy or underwriting guidelines.

Internal Loan Review

The bank's internal loan review system and risk management processes are essential to effective portfolio management and internal controls. Similar to any lending product, examiners should consider whether floor-plan loans are subject to regular credit reviews and compliance control processes. Internal loan review staff performing the review of floor-plan loans should ensure that bank lending staff have performed all procedures related to verifying the existence and value of the related collateral. Internal loan review staff should also assess compliance with the bank's policies and procedures; determine the effectiveness of collateral reviews and controls; and report any deficiencies in the floor-plan lending activity to senior management and the board of directors.

Internal Audit

The bank's internal audit program should include regular reviews of the floor-plan lending activities. Examiners should consider whether internal audit staff assess the adequacy of controls and adherence to policies and procedures. In addition, examiners should consider whether audit staff accompany the bank's floor-plan inspector during inventory inspections as an additional quality control measure and to deter bank staff collusion with the dealer. Appropriate audit staff should verify the inventory subject to each floor-plan loan during the regularly conducted audits. External audit services may be contracted by the dealer or the bank to provide independent assessments of the dealer's business processes and controls. The bank may hire inventory audit servicers to assist on inspections of floor-plan loan inventory, however, bank management is still responsible for providing appropriate oversight of these third-party services.

Supervisory Considerations for Assessing the Risk Rating Floor-Plan Loans

Examiners should understand the primary and secondary sources of repayment when assessing the risk rating of floor-plan loans. A floor-plan loan's primary source of repayment is cash received from the sale of the assigned collateral. The secondary source of repayment is the dealer's cash flow from operations. Examiners should consider the following factors when assessing the appropriate regulatory risk rating of a floor-plan loan:

- quality and liquidity of inventory as demonstrated through the dealer's sales, inventory turnover, and payment history;
- strength of the credit's structure and controls;
- borrower's financial condition, including liquidity and capital;
- actual operating performance of the dealer versus planned operating performance;
- quality and performance of the indirect loans generated by the dealer under the floor-plan facility; and
- strength and reliability of the dealership's cash flow from operations.

In assessing the strength and reliability of a dealership's operating cash flow, examiners should consider whether the dealership can service the interest on the floor-plan facility, consistent with the expectation for a short-term working capital line of credit. A dealership's operating cash flow also should be able to meet the principal curtailment requirements and pay any residual amounts under the floor-plan facility, in case the dealer liquidates the inventory below the original loan amount. A dealership's operating cash flow becomes more important when the floor-plan lender does not exclusively finance all of the dealer's inventory or when the dealer has a broad range of income sources not directly related to the inventory under the floor-plan facility. Operating cash flow is also important because a floor-plan facility typically finances up to 100 percent of the cost of collateral and does not have the excess collateral protection typically seen with an asset-based loan with a strong borrowing base limit.

Examiners should review sources of repayment or other mitigating factors in assessing the credit rating of a poorly performing floor-plan facility. Examples of other sources of repayment and mitigating factors include other liquidity sources, guarantors, and manufacturer support programs.

1. Determine whether the floor-plan loan policy is adequate. An appropriate policy generally
   - defines qualified borrowers;
   - defines permissible types of merchandise to be financed;
   - establishes guidelines for granting and monitoring floor-plan loans;
   - establishes individual and aggregate limits based on relevant risk factors (such as product category, vehicle type, market) relative to capital and total loans;
   - establishes loan-to-value collateral requirements;
   - establishes collateral documentation standards and lien perfection procedures;
   - establishes guidelines for holding titles and other ownership documents;
   - establishes collateral inspection guidelines;
   - defines curtailment requirements;
   - details guidelines for obtaining and evaluating borrower financial statements at origination and periodically thereafter;
   - establishes guidelines for obtaining manufacturer repurchase agreements;
   - defines requirements for obtaining intercreditor agreements; and
   - establishes guidelines for tri-party (manufacturer, dealer, and bank) floor-plan agreements.
2. Determine whether underwriting and administration procedures are appropriate. Appropriate procedures generally address expectations for bank staff to perform the following tasks (with adequate segregation of duties):
   - conduct floor-plan inspections (generally conducted monthly based on inventory turnover);
   - follow procedures for the reviewing and retaining inspection reports;
   - resolve discrepancies identified during floor-plan inspections;
   - evaluate dealers' financial statements (for new vehicle dealers, these are the statements submitted to the manufacturer that contain details regarding dealership operations and compliance with manufacturer standards); and
   - review floor-plan agreements and borrowers' compliance with the agreements.
3. Review a sample of floor-plan arrangements. Determine whether the files contain, as necessary, appropriate documentation. Appropriate documentation generally includes
   - periodic analysis of the creditworthiness and performance of the relationship;
   - floor-plan agreements;
   - hazard insurance with the bank named as loss payee;
   - collateral valuations, such as National Automobile Dealers Association used car guide;
   - manufacturer's invoices for new units;
   - drafting agreements with manufacturers;
   - floor-plan inspections;
   - financing statement (and related searches) filed with the applicable state agency;
     — Ideally, there are at least two Uniform Commercial Code searches with the Secretary of State or applicable state agency. The first search should be completed before filing to determine the existence of prior secured creditors. The second search should be after filing—and before disbursement—to determine whether the bank's security interest was appropriately recorded.
   - inter-creditor agreements, if the borrower has more than one floor-plan creditor;
   - Manufacturer's Statement of Origin (MSO), titles, and trust receipts;
     — Titles and MSOs may be retained by the borrower to facilitate the sales process, for example to get a new title issued for a sold vehicle. If the borrower is in weak financial condition, banks often hold these documents. In most banks, the security interest to floor-plan inventory is evidenced by a trust receipt. This document is issued to the lender by the dealer. It establishes the bank's rights to the inventory collateral.
   - wholesale letter of credit and drafting authority; and

- limited power of attorney giving the bank the authority to prepare and sign lien documents for the dealer.

4. Determine whether floor-plan agreements contain the following information:
   - maximum advances for each unit;
     — For new units, advance rates are usually expressed as a percentage of cost. For used units, the advance rate may be expressed as a maximum percentage of value from a defined valuation source, e.g., Kelley Blue Book.
   - method used to advance funds;
     — Methods may include advancing funds directly to the manufacturer or dealer. Drafts advanced directly to a dealer elevate risk to the bank.
   - method used to perfect the security interest (vary by state);
   - location of collateral;
   - frequency of floor-plan inspections;
   - repayment schedule, including the timing of payments following the sale of units;
     — The timing of payments is commonly referred to as the release period. The greater the release period, the more risk assumed by the bank.
   - insurance requirements;
   - repurchase agreement with the manufacturer for new units;
   - periodic curtailment program for unsold units (may not be necessary if there is a repurchase agreement); and
   - loan covenants relating to liquidity levels, working capital, and tangible equity.
     — Examiners should compare bank covenants with any manufacturer-required minimums.
5. Review changes in floor-plan lending activities since the previous examination and determine whether policy guidelines, credit administration practices, and staffing levels are appropriate for current and planned lending strategies.
6. Review dealers' financial statements and assess the ability to service the debt. (Debt and inventory levels should move in the same direction. Be aware that floor-planned items might be shifted between dealers.)
   - Compare the number of units sold as shown on the statement with floor-plan payoff activity.
   - Evaluate the mix of units/vehicles sold (new, used, full-size, compact, etc.).
   - Review the inventory reconcilement. Reconcilements for new and used inventory contain different elements, as shown in the following tables.

For New Inventory

New Unit Inventory (Before LIFO Adj.)	$X,XXXM
Plus New Unit Contracts in Transit*	$X,XXXM
Total New Assets	$X,XXXM
Less New Units Floor-plan Liability	($X,XXXM)
New Unit Equity (Deficit)	$X,XXXM

* Inventory sold through retail installment contracts for which the dealership has not yet been paid

Note: When there is a deficit balance, management typically assesses the deficit relative to the cost of vehicles expected to be sold during the dealership's release period (cost of average day's new vehicle sales times the number of days in the release period). A deficit that significantly exceeds the amount expected based on the release period may indicate a default of the floor-plan agreement. Management's assessment of whether the dealership maintains sufficient cash to offset a deficit should be reviewed in these cases.

For Used Inventory

Used Unit Inventory (Before LIFO Adj.)	$X,XXXM
Plus Used Unit Contracts in Transit	$X,XXXM
Total Used Assets	$X,XXXM
Less Lien Payoff Liability*	($X,XXXM)
Less Used Units Floor-plan Liability	($X,XXXM)
Used Unit Equity (Deficit)	$X,XXXM

* Units taken as trade-ins where the customer's existing loan has not yet been paid-off by the dealership

Because used units are not typically financed at full value, used inventory reconcilements normally show significant used equity. A reconcilement with an equity deficit may indicate a default in the floor-plan agreement and a lack of working capital at the dealership. Well-capitalized dealerships often maintain significant amounts of used-unit equity as a source of working capital, as these units can be quickly converted into cash.

- Evaluate the revenue mix to identify trends in new and used vehicle sales, parts and service revenue, and income from finance and insurance activities (i.e., fee income from financing the loan or the sale of credit life insurance).
- Review accounts payable. Determine whether the dealer owes other dealers for inventory purchases.
- If the dealer has more than one floor-plan creditor, determine how management ensures the dealer is not double pledging the collateral, such as use of an inter-creditor agreement governing collateral allocation in the event of default.
- Review account receivable/payable agings.
- Review all inventory turnover reports.
- Evaluate overdraft activity and returned items for dealers.
- Determine that drafting agreements are not abused by the dealer.
- Assess dealerships' global cash flow to determine its sufficiency to cover fixed and variable expenses, as well as service all debt (including dealership related debt personally owed by dealership principals). (A common reason for floor-plan defaults is the diversion of sale proceeds.)

7. Determine whether the bank is over-advancing funds compared to collateral values. Generally, new and used automobiles are financed at a maximum of 100 percent of invoice cost and 90 percent of wholesale value, respectively. Advance rates for other items (manufactured homes, boats, etc.) are typically capped at 100 percent of the invoice for new units and some percentage of market value for used items.
8. Determine whether the lending staff is familiar with the dollar fluctuations in floor-plan loans and periodically evaluate the level of floor-plan debt relative to inventory values.
9. Determine whether the lending staff is aware of risks associated with inventory financing. The following items may indicate problems with floor-plan arrangements:
   - delinquent notes, unpaid interest, lack of required curtailments, and maturities extended beyond reasonable expectation;
   - dealer errors are increasing (wrong vehicles paid off, wrong vehicles added to floor-plan, sold inventory not paid off, wrong retail draft submitted, etc.);
   - increased number of reversed sales;
   - transfer of vehicles between multiple business locations;
   - errors are predominantly in favor of the dealer;
   - an unusual number of follow-ups are required to resolve errors;
   - previously detected errors continue to occur;
   - employee turnover at the dealership is increasing;
   - the amount of missing information on retail sales is increasing (i.e., folders are missing copies of the sales contract, purchaser's insurance information, forms to register/title the vehicle, etc.);
   - floor-plan activity is not consistent with special promotions at the dealership;
   - vehicles added to demonstrator service occur right before or during a floor-plan inspection (which could indicate misuse of the units); and
   - changes in external factors, such as competition or the national, regional, and local economy.
10. Review floor-plan lending reports generated for senior management and the board of directors.
    - determine the adequacy of the bank's accounting system for floored units (i.e., identified by make, model, vehicle identification number, dealer control number, date floored, and curtailment history).
    - determine whether there are well-developed monitoring systems and risk management practices in place commensurate to the size and complexity of the institution's exposure. Reports for the floor-plan lending portfolio generally should include the following items:
      — overall portfolio exposures;
      — concentrations (i.e., dealers, vehicle types, geographic, risk ratings);
      — policy exceptions, including discrepancies that indicate out-of-trust activity; and

— covenant compliance.

11. Assess the adequacy of the collateral inspections. Consideration should be given to the following:
    - scope and frequency of collateral inspections should match risk profiles and include an element of surprise;
    - expertise and independence of collateral inspectors, including sufficient rotation of inspectors to avert collusion;
    - completeness and accuracy of the inventory reconcilement;
      — Inspections should evidence that the dealer's floored inventory list reconciles to the dealer's general ledger and to the bank's listing of floored units.
    - timely reporting of, and responsiveness to, adverse inspection findings (such as payments outside of the dealership's release period, or use of units not designated as demonstrators);
    - adequacy of the floor-plan inspection template (i.e., serial number, condition, location of unit, and date inspection performed); and
    - independent review of the collateral inspection process.
12. Determine whether designated staff perform the following procedures during floor-plan inspections:
    - check financed units to confirm the accuracy of inventories, physical conditions, locations (if other than normal place of business) and odometer or hour-meter readings, as applicable;
    - investigate discrepancies;
    - promptly notify bank management of inventory not found on the dealer's premises during inspections;
    - maintain written documentation on all inspections, including follow-up on units not found on the dealer's premises;
    - verify that units reported as sold and unpaid are documented by related finance contracts in transit or payments-in-process, and that such processing is reasonable;
    - ensure the dealer immediately pays off units that are reported as sold, but are not in the process of payment and are outside of the established release period; and
    - report inspection results to senior management.
13. If the bank uses a third-party provider for collateral inspections, determine whether the bank has adequate processes and controls to evaluate, establish, maintain, and monitor the relationships.
14. If the situation warrants, examiners should perform a floor-plan inspection or direct management to obtain an independent third-party inspection given conditions, such as
    - infrequent or nonexistent floor-plan inspections;
    - items are consistently found missing during floor-plan inspections;
    - dealer is experiencing financial difficulties;
    - a significant out-of-trust situation was discovered during the bank's most recent inspection of units or reconciliation of the financial statement; and
    - inventory reconcilements reflect an equity deficit that significantly exceeds the amount expected based on the release period.

Leveraged lending has been a financing vehicle for transactions involving mergers and acquisitions, business recapitalizations, and business expansions.[1] It is an important type of financing for national and global economies, and the U.S. financial industry plays an integral role in making credit available and syndicating that credit to investors. Leveraged transactions are characterized by a degree of financial leverage that may significantly exceed industry norms as measured by ratios such as debt-to-assets, debt-to-equity, cash flow-to-total debt, or other ratios and standards that are unique to a particular industry. Leveraged borrowers, however, can have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit-risk exposure and challenges for bank risk-management systems.

Leveraged lending activities can be conducted in a safe-and-sound fashion if pursued with a risk-management structure that provides for the appropriate underwriting, pricing, monitoring, and controls. Comprehensive credit analysis processes, frequent monitoring, and detailed portfolio reports are needed to better understand and manage the inherent risk in leveraged portfolios. Sound valuation methodologies must be used in addition to ongoing stress testing and monitoring.

Financial institutions should ensure they do not unnecessarily heighten risks by originating and then distributing poorly underwritten loans.[2] For example, a poorly underwritten leveraged loan that is pooled with other loans or is participated with other institutions may generate risks for the financial system. The leveraged lending guidance that follows is designed to assist financial institutions in providing leveraged lending to creditworthy borrowers in a safe-and-sound manner.

On March 21, 2013, the Federal Reserve Board, along with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), issued ''Interagency Guidance on Leveraged Lending.''[3] The statement provides guidance about risk rating leveraged-financed loans. See SR-13-3 and its attachment.

INTERAGENCY GUIDANCE ON LEVERAGED LENDING

The vast majority of community banks should not be affected by this guidance, as they have limited involvement in leveraged lending. Community and smaller institutions that are involved in leveraged lending activities should discuss with their primary regulator the implementation of cost-effective controls appropriate for the complexity of their exposures and activities.[4]

Risk-Management Framework

Given the high-risk profile of leveraged transactions, financial institutions engaged in leveraged lending should adopt a risk-management framework that has an intensive and frequent review and monitoring process. The framework should have as its foundation written risk objectives, risk-acceptance criteria, and risk controls. A lack of robust risk-management processes and controls at a financial institution with significant leveraged lending activities could contribute to supervisory findings that the financial institution

1. For the purpose of this guidance, references to leveraged finance, or leveraged transactions encompass the entire debt structure of a leveraged obligor (including loans and letters of credit, mezzanine tranches, senior and subordinated bonds) held by both bank and nonbank investors. References to leveraged lending and leveraged loan transactions and credit agreements refer to all debt with the exception of bond and high-yield debt held by both bank and nonbank investors.

2. For purposes of this guidance, the term ''financial institution'' or ''institution'' includes national banks, federal savings associations, and federal branches and agencies supervised by the OCC; state member banks, bank holding companies, savings and loan holding companies, and all other institutions for which the Federal Reserve is the primary federal supervisor; and state nonmember banks, foreign banks having an insured branch, state savings associations, and all other institutions for which the FDIC is the primary federal supervisor.

3. This guidance augments previously issued supervisory statements on sound credit-risk management. Refer to SR-98-18, ''Lending Standards for Commercial Loans'' (see also sections 2040.1, ''Loan Portfolio Management,'' and 2040.3, ''Loan Portfolio Management—Examination Procedures,'' in this manual).

4. The agencies do not intend that a financial institution that originates a small number of less complex, leveraged loans should have policies and procedures commensurate with a larger, more complex leveraged loan origination business. However, any financial institution that participates in leveraged lending transactions should follow applicable supervisory guidance provided in ''Participations Purchased'' of this section.

is engaged in unsafe and unsound banking practices. This guidance outlines the agencies' minimum expectations on the following topics:

- Leveraged Lending Definition
- General Policy Expectations
- Participations Purchased
- Underwriting Standards
- Valuation Standards
- Pipeline Management
- Reporting and Analytics
- Risk Rating Leveraged Loans
- Credit Analysis
- Problem-Credit Management
- Deal Sponsors
- Credit Review
- Stress Testing
- Conflicts of Interest
- Reputational Risk
- Compliance

Leveraged Lending Definition

The policies of financial institutions should include criteria to define leveraged lending that are appropriate to the institution.[5] For example, numerous definitions of leveraged lending exist throughout the financial services industry and commonly contain some combination of the following:

- proceeds used for buyouts, acquisitions, or capital distributions
- transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) or Senior Debt divided by EBITDA exceed 4.0 * EBITDA or 3.0 * EBITDA, respectively, or other defined levels appropriate to the industry or sector[6]
- a borrower recognized in the debt markets as a highly leveraged firm, which is characterized by a high debt-to-net-worth ratio
- transactions when the borrower's post-financing leverage, as measured by its leverage ratios (for example, debt-to-assets, debt-to-net-worth, debt-to-cash flow, or other similar standards common to particular industries or sectors), significantly exceeds industry norms or historical levels[7]

A financial institution engaging in leveraged lending should define it within the institution's policies and procedures in a manner sufficiently detailed to ensure consistent application across all business lines. A financial institution's definition should describe clearly the purposes and financial characteristics common to these transactions, and should cover risk to the institution from both direct exposure and indirect exposure via limited-recourse financing secured by leveraged loans, or financing extended to financial intermediaries (such as conduits and special purpose entities (SPEs)) that hold leveraged loans.

General Policy Expectations

A financial institution's credit policies and procedures for leveraged lending should address the following:

- Identification of the financial institution's risk appetite, including clearly defined amounts of leveraged lending that the institution is willing to underwrite (for example, pipeline limits) and is willing to retain (for example, transaction and aggregate hold levels). The institution's designated risk appetite should be supported by an analysis of the potential effect on earnings, capital, liquidity, and other risks that result from these positions, and should be approved by its board of directors.
- A limit framework that includes limits or guidelines for single obligors and transactions, aggregate hold portfolio, aggregate pipeline exposure, and industry and geographic concentrations. The limit framework should identify the related management-approval authorities and exception-tracking provisions. In addition to notional pipeline limits, the agencies expect that financial institutions with significant leveraged transactions will imple-

5. This guidance is not meant to include asset-based loans unless such loans are part of the entire debt structure of a leveraged obligor. Asset-based lending is a distinct segment of the loan market that is tightly controlled or fully monitored, secured by specific assets, and usually governed by a borrowing formula (or ''borrowing base'').

6. Cash should not be netted against debt for purposes of this calculation.

7. The designation of a financing as ''leveraged lending'' is typically made at loan origination, modification, extension, or refinancing. ''Fallen angels'' or borrowers that have exhibited a significant deterioration in financial performance after loan inception and subsequently become highly leveraged would not be included within the scope of this guidance, unless the credit is modified, extended, or refinanced.

ment underwriting-limit frameworks that assess stress losses, flex terms, economic capital usage, and earnings at risk or that otherwise provide a more nuanced view of potential risk.[8]
- Procedures for ensuring the risks of leveraged lending activities are appropriately reflected in an institution's allowance for loan and lease losses (ALLL) and capital adequacy analyses.
- Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms.
- Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors.
- Expected risk-adjusted returns for leveraged transactions.
- Minimum underwriting standards (see the "Underwriting Standards" section below).
- Effective underwriting practices for primary loan origination and secondary loan acquisition.

Participations Purchased

Financial institutions purchasing participations and assignments in leveraged lending transactions should make a thorough, independent evaluation of the transaction and the risks involved before committing any funds.[9] They should apply the same standards of prudence, credit assessment and approval criteria, and in-house limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for

- obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, Uniform Commercial Code (UCC) searches, and other relevant documents;
- carefully monitoring the borrower's performance throughout the life of the loan; and
- establishing appropriate risk-management guidelines as described in this document.

Underwriting Standards

A financial institution's underwriting standards should be clear, written, and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions. A financial institution should have clear underwriting limits regarding leveraged transactions, including the size that the institution will arrange both individually and in the aggregate for distribution. The originating institution should be mindful of reputational risks associated with poorly underwritten transactions, as these risks may find their way into a wide variety of investment instruments and exacerbate systemic risks within the general economy. At a minimum, an institution's underwriting standards should consider the following:

- Whether the business premise for each transaction is sound and the borrower's capital structure is sustainable regardless of whether the transaction is underwritten for the institution's own portfolio or with the intent to distribute. The entirety of a borrower's capital structure should reflect the application of sound financial analysis and underwriting principles.
- A borrower's capacity to repay and the ability to de-lever to a sustainable level over a reasonable period. As a general guide, institutions also should consider whether base-case cash-flow projections show the ability to fully amortize senior secured debt or repay a significant portion of total debt over the medium term.[10] Also, projections should

8. Flex terms allow the arranger to change interest-rate spreads during the syndication process to adjust pricing to current liquidity levels.

9. Refer to other joint agency guidance regarding purchased participations: OCC *Loan Portfolio Management Handbook*, www.occ.gov/publications/publications-by-type/comptrollers-handbook/lpm.pdf, "Loan Participations"; Board *Commercial Bank Examination Manual*, section 2045.1, "Loan Participations, the Agreements and Participants"; and FDIC *Risk Management Manual of Examination Policies*, "Section 3.2—Loans," www.fdic.gov/regulations/safety/manual/section3-2.html#otherCredit, Loan Participations (last updated Feb. 2, 2005).

10. In general, the base-case cash-flow projection is the borrower or deal sponsor's expected estimate of financial performance using the assumptions that are deemed most likely to occur. The financial results for the base case should be better than those for the conservative case but worse than those for the aggressive or upside case. A financial institution may adjust the base-case financial projections, if necessary. The most realistic financial projections should be used when

include one or more realistic downside scenarios that reflect key risks identified in the transaction.
- Expectations for the depth and breadth of due diligence on leveraged transactions. This should include standards for evaluating various types of collateral, with a clear definition of credit-risk-management's role in such due diligence.
- Standards for evaluating expected risk-adjusted returns. The standards should include identification of expected distribution strategies, including alternative strategies for funding and disposing of positions during market disruptions, and the potential for losses during such periods.
- The degree of reliance on enterprise value and other intangible assets for loan repayment, along with acceptable valuation methodologies, and guidelines for the frequency of periodic reviews of those values.
- Expectations for the degree of support provided by the sponsor (if any), taking into consideration the sponsor's financial capacity, the extent of its capital contribution at inception, and other motivating factors. Institutions looking to rely on sponsor support as a secondary source of repayment for the loan should be able to provide documentation, including, but not limited to, financial or liquidity statements, showing recently documented evidence of the sponsor's willingness and ability to support the credit extension.
- Whether credit-agreement terms allow for the material dilution, sale, or exchange of collateral or cash-flow-producing assets without lender approval.
- Credit-agreement covenant protections, including financial performance (such as debt-to-cash flow, interest coverage, or fixed-charge coverage), reporting requirements, and compliance monitoring. Generally, a leverage level after planned asset sales (that is, the amount of debt that must be serviced from operating cash flow) in excess of 6* Total Debt/EBITDA raises concerns for most industries.
- Collateral requirements in credit agreements that specify acceptable collateral and risk-appropriate measures and controls, including acceptable collateral types, loan-to-value guidelines, and appropriate collateral-valuation methodologies. Standards for asset-based loans that are part of the entire debt structure also should outline expectations for the use of collateral controls (for example, inspections, independent valuations, and payment lockbox), other types of collateral and account maintenance agreements, and periodic reporting requirements.
- Whether loan agreements provide for distribution of ongoing financial and other relevant credit information to all participants and investors.

Nothing in the preceding standards should be considered to discourage providing financing to borrowers engaged in workout negotiations, or as part of a pre-packaged financing under the bankruptcy code. Neither are they meant to discourage well-structured, standalone asset-based credit facilities to borrowers with strong lender monitoring and controls, for which a financial institution should consider separate underwriting and risk-rating guidance.

Valuation Standards

Institutions often rely on enterprise value and other intangibles when (1) evaluating the feasibility of a loan request; (2) determining the debt reduction potential of planned asset sales; (3) assessing a borrower's ability to access the capital markets; and (4) estimating the strength of a secondary source of repayment. Institutions may also view enterprise value as a useful benchmark for assessing a sponsor's economic incentive to provide financial support. Given the specialized knowledge needed for the development of a credible enterprise valuation and the importance of enterprise valuations in the underwriting and ongoing risk-assessment processes, enterprise valuations should be performed by qualified persons independent of an institution's origination function.

There are several methods used for valuing businesses. The most common valuation methods are assets, income, and market. Asset valuation methods consider an enterprise's underlying assets in terms of its net going-concern or liquidation value. Income valuation methods consider an enterprise's ongoing cash flows or earnings and apply appropriate capitalization or discounting techniques. Market valuation methods derive value multiples from comparable company data or sales transactions. However, final value estimates should be based on the

measuring a borrower's capacity to repay and de-lever.

method or methods that give supportable and credible results. In many cases, the income method is generally considered the most reliable.

There are two common approaches employed when using the income method. The ‘‘capitalized cash flow’’ method determines the value of a company as the present value of all future cash flows the business can generate in perpetuity. An appropriate cash flow is determined and then divided by a risk-adjusted capitalization rate, most commonly the weighted average cost of capital. This method is most appropriate when cash flows are predictable and stable. The ‘‘discounted cash flow’’ method is a multiple-period valuation model that converts a future series of cash flows into current value by discounting those cash flows at a rate of return (referred to as the ‘‘discount rate’’) that reflects the risk inherent therein. This method is most appropriate when future cash flows are cyclical or variable over time. Both income methods involve numerous assumptions, and therefore, supporting documentation should fully explain the evaluator’s reasoning and conclusions.

When a borrower is experiencing a financial downturn or facing adverse market conditions, a lender should reflect those adverse conditions in its assumptions for key variables such as cash flow, earnings, and sales multiples when assessing enterprise value as a potential source of repayment. Changes in the value of a borrower’s assets should be tested under a range of stress scenarios, including business conditions more adverse than the base-case scenario. Stress tests of enterprise values and their underlying assumptions should be conducted and documented at origination of the transaction and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The institution should perform its own discounted cash-flow analysis to validate the enterprise value implied by proxy measures such as multiples of cash flow, earnings, or sales.

Enterprise value estimates derived from even the most rigorous procedures are imprecise and ultimately may not be realized. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral should have policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins. Based on the nature of an institution’s leveraged lending activities, the institution should establish limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value. Regardless of the methodology used, the assumptions underlying enterprise value estimates should be clearly documented, well supported, and understood by the institution’s appropriate decisionmakers and risk-oversight units. Further, an institution’s valuation methods should be appropriate for the borrower’s industry and condition.

Pipeline Management

Market disruptions can substantially impede the ability of an underwriter to consummate syndications or otherwise sell down exposures, which may result in material losses. Accordingly, financial institutions should have strong risk management and controls over transactions in the pipeline, including amounts to be held and those to be distributed. A financial institution should be able to differentiate transactions according to tenor, investor class (for example, pro-rata and institutional), structure, and key borrower characteristics (for example, industry).

In addition, an institution should develop and maintain the following:

- A clearly articulated and documented appetite for underwriting risk that considers the potential effects on earnings, capital, liquidity, and other risks that result from pipeline exposures.
- Written policies and procedures for defining and managing distribution failures and ‘‘hung’’ deals, which are identified by an inability to sell down the exposure within a reasonable period (generally 90 days from transaction closing). The financial institution’s board of directors and management should establish clear expectations for the disposition of pipeline transactions that are not sold according to their original distribution plan. Such transactions that are subsequently reclassified as hold-to-maturity should also be reported to management and the board of directors.
- Guidelines for conducting periodic stress tests on pipeline exposures to quantify the potential impact of changing economic and market conditions on the institution’s asset quality, earnings, liquidity, and capital.
- Controls to monitor performance of the pipeline against original expectations, and regular reports of variances to management, including the amount and timing of syndication and

distribution variances and reporting of recourse sales to achieve distribution.
- Reports that include individual and aggregate transaction information that accurately risk rates credits and portrays risk and concentrations in the pipeline.
- Limits on aggregate pipeline commitments.
- Limits on the amount of loans that an institution is willing to retain on its own books (that is, borrower, counterparty, and aggregate hold levels), and limits on the underwriting risk that will be undertaken for amounts intended for distribution.
- Policies and procedures that identify acceptable accounting methodologies and controls in both functional as well as dysfunctional markets, and that direct prompt recognition of losses in accordance with generally accepted accounting principles.
- Policies and procedures addressing the use of hedging to reduce pipeline and hold exposures, which should address acceptable types of hedges and the terms considered necessary for providing a net credit exposure after hedging.
- Plans and provisions addressing contingent liquidity and compliance with the Board's Regulation W (12 CFR part 223) when market illiquidity or credit conditions change, interrupting normal distribution channels.

Reporting and Analytics

The agencies expect financial institutions to diligently monitor higher-risk credits, including leveraged loans. A financial institution's management should receive comprehensive reports about the characteristics and trends in such exposures at least quarterly, and summaries should be provided to the institution's board of directors. Policies and procedures should identify the fields to be populated and captured by a financial institution's Management Information Systems, which should yield accurate and timely reporting to management and the board of directors that may include the following:

- Individual and portfolio exposures within and across all business lines and legal vehicles, including the pipeline.
- Risk rating distribution and migration analysis, including maintenance of a list of those borrowers who have been removed from the leveraged portfolio due to improvements in their financial characteristics and overall risk profile.
- Industry mix and maturity profile.
- Metrics derived from probabilities of default and loss given default.
- Portfolio performance measures, including noncompliance with covenants, restructurings, delinquencies, non-performing amounts, and charge-offs.
- Amount of impaired assets and the nature of impairment (that is, permanent, or temporary), and the amount of the ALLL attributable to leveraged lending.
- The aggregate level of policy exceptions and the performance of that portfolio.
- Exposures by collateral type, including unsecured transactions and those where enterprise value will be the source of repayment for leveraged loans. Reporting should also consider the implications of defaults that trigger pari passu (in a fair way) treatment for all lenders and, thus, dilute the secondary support from the sale of collateral.
- Secondary-market-pricing data and trading volume, when available.
- Exposures and performance by deal sponsors. Deals introduced by sponsors may, in some cases, be considered exposure to related borrowers. An institution should identify, aggregate, and monitor potential related exposures.
- Gross and net exposures, hedge counterparty concentrations, and policy exceptions.
- Actual versus projected distribution of the syndicated pipeline, with regular reports of excess levels over the hold targets for the syndication inventory. Pipeline definitions should clearly identify the type of exposure. This includes committed exposures that have not been accepted by the borrower, commitments accepted but not closed, and funded and unfunded commitments that have closed but have not been distributed.
- Total and segmented leveraged lending exposures, including subordinated debt and equity holdings, alongside established limits. Reports should provide a detailed and comprehensive view of global exposures, including situations when an institution has indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative.
- Borrower and counterparty leveraged lending reporting should consider exposures booked in other business units throughout the institu-

tion, including indirect exposures such as default swaps and total return swaps, naming the distributed paper as a covered or referenced asset or collateral exposure through repo transactions. Additionally, the institution should consider positions held in available-for-sale or traded portfolios or through structured investment vehicles owned or sponsored by the originating institution or its subsidiaries or affiliates.

Risk Rating Leveraged Loans

Previously, the agencies issued guidance on rating credit exposures and credit-rating systems, which applies to all credit transactions, including those in the leveraged lending category.[11]

The risk rating of leveraged loans involves the use of realistic repayment assumptions to determine a borrower's ability to de-lever to a sustainable level within a reasonable period. For example, supervisors commonly assume that the ability to fully amortize senior secured debt or the ability to repay at least 50 percent of total debt over a five- to seven-year period provides evidence of adequate repayment capacity. If the projected capacity to pay down debt from cash flow is nominal with refinancing the only viable option, the credit will usually be adversely rated even if it has been recently underwritten. In cases when leveraged loan transactions have no reasonable or realistic prospects to de-lever, a substandard rating is likely. Furthermore, when assessing debt service capacity, extensions and restructures should be scrutinized to ensure that the institution is not merely masking repayment capacity problems by extending or restructuring the loan.

If the primary source of repayment becomes inadequate, the agencies believe that it would generally be inappropriate for an institution to consider enterprise value as a secondary source of repayment unless that value is well supported. Evidence of well-supported value may include binding purchase and sale agreements with qualified third parties or thorough asset valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, when a portion of the loan may not be protected by pledged assets or a well-supported enterprise value, examiners generally will rate that portion doubtful or loss and place the loan on nonaccrual status.

11. Board SR Letter 98-25, "Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations"; OCC *Comptroller's Handbooks* "Rating Credit Risk" and "Leveraged Lending"; and FDIC *Risk Management Manual of Examination Policies*, "Loan Appraisal and Classification."

Credit Analysis

Effective underwriting and management of leveraged lending risk is highly dependent on the quality of analysis employed during the approval process as well as ongoing monitoring. A financial institution's policies should address the need for a comprehensive assessment of financial, business, industry, and management risks including, whether

- cash-flow analyses rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- liquidity analyses include performance metrics appropriate for the borrower's industry, predictability of the borrower's cash flow, measurement of the borrower's operating cash needs, and ability to meet debt maturities;
- projections exhibit an adequate margin for unanticipated merger-related integration costs;
- projections are stress tested for one or more downside scenarios, including a covenant breach;
- transactions are reviewed at least quarterly to determine variance from plan, the related risk implications, and the accuracy of risk ratings and accrual status. From inception, the credit file should contain a chronological rationale for and analysis of all substantive changes to the borrower's operating plan and variance from expected financial performance;
- enterprise and collateral valuations are independently derived or validated outside of the origination function, are timely, and consider potential value erosion;
- collateral liquidation and asset sale estimates are based on current market conditions and trends;
- potential collateral shortfalls are identified and factored into risk rating and accrual decisions;
- contingency plans anticipate changing conditions in debt or equity markets when expo-

sures rely on refinancing or the issuance of new equity; and
- the borrower is adequately protected from interest rate and foreign exchange risk.

Problem-Credit Management

A financial institution should formulate individual action plans when working with borrowers experiencing diminished operating cash flows, depreciated collateral values, or other significant plan variances. Weak initial underwriting of transactions, coupled with poor structure and limited covenants, may make problem-credit discussions and eventual restructurings more difficult for an institution as well as result in less favorable outcomes.

A financial institution should formulate credit policies that define expectations for the management of adversely rated and other high-risk borrowers whose performance departs significantly from planned cash flows, asset sales, collateral values, or other important targets. These policies should stress the need for workout plans that contain quantifiable objectives and measureable time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests, sale of the credit in the secondary market, or liquidation of collateral. Problem credits should be reviewed regularly for risk rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

Deal Sponsors

A financial institution that relies on sponsor support as a secondary source of repayment should develop guidelines for evaluating the qualifications of financial sponsors and should implement processes to regularly monitor a sponsor's financial condition. Deal sponsors may provide valuable support to borrowers such as strategic planning, management, and other tangible and intangible benefits. Sponsors may also provide sources of financial support for borrowers that fail to achieve projections. Generally, a financial institution rates a borrower based on an analysis of the borrower's standalone financial condition. However, a financial institution may consider support from a sponsor in assigning internal risk ratings when the institution can document the sponsor's history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. However, even with documented capacity and a history of support, the sponsor's potential contributions may not mitigate supervisory concerns absent a documented commitment of continued support. An evaluation of a sponsor's financial support should include the following:

- the sponsor's historical performance in supporting its investments, financially and otherwise
- the sponsor's economic incentive to support, including the nature and amount of capital contributed at inception
- documentation of degree of support (for example, a guarantee, comfort letter, or verbal assurance)
- consideration of the sponsor's contractual investment limitations
- to the extent feasible, a periodic review of the sponsor's financial statements and trends, and an analysis of its liquidity, including the ability to fund multiple deals
- consideration of the sponsor's dividend and capital contribution practices
- the likelihood of the sponsor supporting a particular borrower compared to other deals in the sponsor's portfolio
- guidelines for evaluating the qualifications of a sponsor and a process to regularly monitor the sponsor's performance

Credit Review

A financial institution should have a strong and independent credit-review function that demonstrates the ability to identify portfolio risks and documented authority to escalate inappropriate risks and other findings to its senior management. Due to the elevated risks inherent in leveraged lending, and depending on the relative size of a financial institution's leveraged lending business, the institution's credit-review function should assess the performance of the leveraged portfolio more frequently and in greater depth than other segments in the loan portfolio. Such assessments should be performed by individuals with the expertise and experience for these types of loans and the borrower's industry. Portfolio reviews should generally be conducted at least annually. For many financial institutions, the risk characteristics of leveraged portfolios, such as high reliance on enterprise value, concentrations, adverse risk rating trends, or portfolio performance, may dictate reviews that are more frequent.

A financial institution should staff its internal credit-review function appropriately and ensure that the function has sufficient resources to ensure timely, independent, and accurate assessments of leveraged lending transactions. Reviews should evaluate the level of risk, risk rating integrity, valuation methodologies, and the quality of risk management. Internal credit reviews should include the review of the institution's leveraged lending practices, policies, and procedures to ensure that they are consistent with regulatory guidance.

Stress Testing

A financial institution should develop and implement guidelines for conducting periodic portfolio stress tests on loans originated to hold as well as loans originated to distribute, and sensitivity analyses to quantify the potential impact of changing economic and market conditions on its asset quality, earnings, liquidity, and capital.[12] The sophistication of stress testing practices and sensitivity analyses should be consistent with the size, complexity, and risk characteristics of the institution's leveraged loan portfolio. To the extent a financial institution is required to conduct enterprise-wide stress tests, the leveraged portfolio should be included in any such tests.

12. See interagency guidance "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets" (see Board SR Letter 12-7 and its attachment), 77 *Fed. Reg.* 29458 (May 17, 2012), at www.gpo.gov/fdsys/pkg/FR-2012-05-17/html/2012-11989.htm, and the joint "Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks," May 14, 2012, by the OCC at www.occ.gov/news-issuances/news-releases/2012/nr-ia-2012-76a.pdf; the Board at www.federalreserve.gov/newsevents/press/bcreg/bcreg20120514b1.pdf; and the FDIC at www.fdic.gov/news/news/press/2012/pr12054a.pdf. See also FDIC final rule, Annual Stress Test, 77 *Fed. Reg.* 62417 (Oct. 15, 2012) (to be codified at 12 CFR part 325, subpart C).

Conflicts of Interest

A financial institution should develop appropriate policies and procedures to address and to prevent potential conflicts of interest when it has equity and lending positions. For example, an institution may be reluctant to use an aggressive collection strategy with a problem borrower because of the potential impact on the value of an institution's equity interest. A financial institution may encounter pressure to provide financial or other privileged client information that could benefit an affiliated equity investor. Such conflicts also may occur when the underwriting financial institution serves as financial advisor to the seller and simultaneously offers financing to multiple buyers (that is, stapled financing). Similarly, there may be conflicting interests among the different lines of business within a financial institution or between the financial institution and its affiliates. When these situations occur, potential conflicts of interest arise between the financial institution and its customers. Policies and procedures should clearly define potential conflicts of interest, identify appropriate risk-management controls and procedures, enable employees to report potential conflicts of interest to management for action without fear of retribution, and ensure compliance with applicable laws. Further, management should have an established training program for employees on appropriate practices to follow to avoid conflicts of interest and provide for reporting, tracking, and resolution of any conflicts of interest that occur.

Reputational Risk

Leveraged lending transactions are often syndicated through the financial and institutional markets. A financial institution's apparent failure to meet its legal responsibilities in underwriting and distributing transactions can damage its market reputation and impair its ability to compete. Similarly, a financial institution that distributes transactions, which over time have significantly higher default or loss rates and performance issues, may also see its reputation damaged.

Compliance

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure potential conflicts are avoided and laws and regulations are adhered to, an institution's independent compliance function should periodically review the institution's leveraged lending activity. This guidance is consistent with the principles of safety and soundness and other agency guidance related to commercial lending.

In particular, because leveraged transactions often involve a variety of types of debt and bank products, a financial institution should ensure that its policies incorporate safeguards to prevent violations of anti-tying regulations. Section 106(b) of the Bank Holding Company Act Amendments of 1970[13] prohibits certain forms of product tying by financial institutions and their affiliates. The intent behind Section 106(b) is to prevent financial institutions from using their market power over certain products to obtain an unfair competitive advantage in other products.

In addition, equity interests and certain debt instruments used in leveraged transactions may constitute "securities" for the purposes of federal securities laws. When securities are involved, an institution should ensure compliance with applicable securities laws, including disclosure and other regulatory requirements. An institution should also establish policies and procedures to appropriately manage the internal dissemination of material, nonpublic information about transactions in which it plays a role.

13. 12 USC 1972.

1. *Risk-Management Framework, Definition, and Policy Expectations.* To determine
   a. whether the institution has established a sound definition of leveraged lending that is appropriate for the types of leveraged loans that are underwritten and if it can be applied across all business lines;
   b. whether it has adjusted (if necessary) its risk appetite and limit structure (including pipeline limits and overall portfolio limits) to conform with the institution's definition of leveraged lending and whether it has the necessary reporting in place to assess conformance with limits.
   c. if there are appropriate policies and procedures limits in place and if the institution maintains sound leveraged lending standards both for transactions that it intends to hold as well as transactions that are underwritten to distribute.
   d. if the institution's risk-management structure has strong and effective processes and controls and if they are appropriate based on its leveraged lending activity.
2. *Participations Purchased.* To ensure that the institution applies the same standards of prudence and credit assessment techniques and in-house limits that would apply as if it had originated the loan(s).
3. *Underwriting Standards.* To assess the effectiveness of the institution's underwriting policy standards for leveraged lending to determine whether they
   a. are clear, written, and measurable;
   b. contain underwriting limits that reflect the institution's definition and risk appetite for leveraged lending;
   c. are applied equally to loans that are originated to be held and to loans that are originated to distribute; and
   d. fully reflect the underwriting standards listed in the guidance, including
      i. sound business premise and sustainable capital structure for each transaction
      ii. capacity to repay and ability to de-lever to a sustainable level over a reasonable period
      iii. appropriate depth and breadth of due diligence
      iv. standards for valuating expected risk-adjusted returns
      v. appropriate credit agreement covenant protections
      vi. acceptable collateral agreements.
4. *Valuation Standards.* To determine
   a. whether enterprise valuation methodologies are appropriate to the borrower's industry and condition;
   b. whether the assumptions are clearly documented, well supported, and understood by the institution's appropriate decision makers and risk-oversight units;
   c. whether enterprise valuations are performed by qualified persons independent of an institution's origination function;
   d. whether an institution has policies and provides for appropriate loan-to-value ratios, discount rates and collateral margins for loans dependent on enterprise value or illiquid and hard-to-value collateral.
5. *Pipeline Management.* To find out if there are strong risk-management standards and controls over transactions in and to the pipeline and if those standards are applied uniformly to transactions held in the portfolio and those that are distributed.
6. *Reporting and Analytics.*
   a. To determine if individual and portfolio exposures within and across all business lines and legal vehicles are captured and reported in the appropriate amount of detail to senior management and the board.
   b. To determine if the necessary risk information (as outlined in the guidance) about leveraged lending exposures (portfolio holds and pipeline exposures) are captured in reports that are distributed timely and that adequate information is distributed to senior management and the institution's board of directors at least quarterly.
7. *Risk Rating.* To verify that leveraged loans are risk rated based on the borrower's ability to repay and de-lever to a sustainable level.

8. *Credit Analysis.*
   a. To test transactions to determine if underwriting practices are effective and comprehensive.
   b. To determine if individual leveraged lending exposures contain a comprehensive assessment of financial, business, industry, and management risks based on the elements of the guidance.
9. *Problem Credit Management.*
   a. To ascertain whether the institution formulates individual action plans and expectations.
   b. To evaluate workout plans to confirm that they contain quantifiable objectives and measureable time frames.
   c. To determine if problem credits are regularly reviewed for risk-rating accuracy, accrual status, impairment status, and charge off.
10. *Deal Sponsors.*
    a. To determine if the institution has guidelines for evaluating deal sponsors that are based on the sponsor's ability and willingness to support the transaction where sponsors are viewed as a source of repayment.
11. *Credit Review.*
    a. To ensure that the institution regularly conducts an independent credit review of the leveraged lending portfolio more frequently and in greater depth than other segments of the portfolio generally at least annually. For firms making significant changes to policies, underwriting standards, procedures, etc., ensure that a credit review is scheduled to test compliance with changes.
    b. To ensure that credit review personnel have the expertise and experience to evaluate leveraged loans.
12. *Stress Testing.*
    a. To determine if the institution is conducting periodic loan- and portfolio stress tests on leveraged loan portfolios or if the portfolio has been incorporated into enterprise-wide stress testing practices.
    b. To verify the effectiveness of the institution's periodic portfolio stress tests (in accordance with stress testing guidance) in identifying what effect economic and market events could have on the institution's financial condition and leveraged lending transactions.
13. *Conflict of Interest.* To determine
    a. if policies identify and if there are procedures to address transactions in which the institution holds both an equity and lending positions;
    b. the adequacy and effectiveness of controls and training programs that aim to curb any potential conflicts of interests that result from leveraged lending.
14. *Reputational Risk.*
    a. To determine if the institution has suffered reputational damage by failing to meet its legal responsibilities in underwriting and syndicating leveraged loan transactions into the wider financial market.

Complete or update the Leveraged Lending Internal Control Questionnaire if selected for implementation.

1. Based on an evaluation of internal controls, determine the scope of the examination. The scope should include exposures related through common ownership, guarantors, or sponsors. Also include direct and indirect leveraged lending exposure found in financial intermediaries formed to house or distribute leveraged loans (for example, CLOs, SPEs, conduits, etc.).
2. Examination procedures should include both a policy review and transaction testing approach to determine the effectiveness of the institution's leveraged lending control process.

If the institution is found to lack robust risk-management processes and controls around leveraged lending that reinforces the institution's risk profile, a supervisory finding of unsafe and unsound banking practices should be considered.

3. Applicability/Risk-Management Framework
   a. At the start of the examination, ascertain whether the institution has adopted an appropriate risk-management framework for leveraged lending that includes robust policies, procedures, and risk limits that have been approved by the board of directors.
   b. Implementation of this guidance should be consistent with the size and risk profile of the institution.
   c. All aspects of the guidance should be applied to institutions that originate and distribute leveraged loans.
   d. The section on Participations Purchased should be applied to banking organizations that have limited involvement in leveraged lending; community banks overall may not be materially affected by the guidance.
4. Definition of Leveraged Lending
   a. Determine if the institution has a written policy for leveraged lending and if that policy contains criteria for defining leveraged lending that are appropriate for the institution and consistent with the guidance standards.
   b. Determine if the institution's definition includes related exposures and direct and indirect exposures.
5. General Policy Expectations
   a. Review the policy for the key risk elements referred to in the guidance (See the section on General Policy Expectations in the guidance and in the Internal Control Questionnaire). Determine if the policy includes the following elements:
      - Risk Appetite that clearly defines the amount of leveraged lending the institution is willing to underwrite and is willing to retain.
      - Limit Framework for aggregate portfolio held on balance sheet, single obligors and transactions, aggregate pipeline exposure, industry and geographic concentrations. For institutions with significant underwriting exposure, determine if limits have been established for stress losses, flex terms, economic capital, or earnings at risk associated with leveraged loans.
      - Allowance for loan and lease losses (ALLL) and capital adequacy analysis that reflect the risk of leveraged lending activities.
      - Credit approval and underwriting authorities.
      - Guidelines for senior management oversight and timely reporting to senior management and the board of directors.
      - Expected risk adjusted returns.
      - Minimum underwriting standards.
      - Underwriting practices for origination and secondary loan acquisition.
6. Participations Purchased
   a. Ascertain if the institution participating or purchasing into a leveraged loan has a clear understanding of the credit and the risks involved and also has a clear understanding of its rights and responsibilities under the participation agreement.
   b. Determine if the institution has conducted its own independent underwriting of participations and has applied the same standards of prudence, credit assessment techniques, and in-house limits as if the institution had originated the loan(s).

   c. Verify that the institution has received copies of all participation documents and any other documents relevant to the credit transaction(s).
7. Underwriting Standards
   a. Determine if the institution employs similar and consistent underwriting standards for leveraged loans it plans to hold or it plans to distribute.
      - Confirm that the institution's underwriting standards are clear, written, measurable, and reflect the institution's policy-based risk appetite for leveraged lending.
      - Evaluate the underwriting policies and standards and determine if they contain the elements found in guidance. (Refer to the section on Underwriting Standards in the guidance and in the Internal Control Questionnaire.)
8. Valuation Standards
   a. Confirm that the institution has policies and procedures in place for estimating enterprise value or for valuing other illiquid collateral. If enterprise value is relied on as a secondary source of repayment, determine the following:
      - If one or a combination of the three methods referred to in the guidance is used (asset, income, or market valuation).
      - If the underlying assumptions and the resulting values are well documented, supportable, and credible. (Refer to the Valuations Standards section of the guidance and the Internal Control Questionnaire.)
      - If enterprise value was calculated by qualified persons independent of the origination function.
      - If stress tests of key enterprise value variables and assumptions (such as cash flow earnings and sales multiples) are conducted.
      - That firms have policies that provide for appropriate loan-to-value ratios, discount rates and collateral margins.
      - If the institution has established limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value.
9. Pipeline Management
   a. Determine if the institution has strong risk management and controls that are extended to deals in the pipeline, whether those deals are intended for hold, or if they are intended for distribution.
      - Determine if the institution has policies and procedures for handling distribution failures.
      - Determine if there are procedures for stress testing pipeline deals.
      - Ascertain if management reports show that transactions can be differentiated based on their key characteristics, tenor, and investor class (pro-rata and institutional), structure, and key borrower characteristics (for example, industry).
      - Determine if there are clearly articulated rationales for the effectiveness of hedging methods and if there is appropriate measurement and monitoring.
      - Confirm that the institution has developed and maintained the pipeline procedures referred to in the guidance (see the section on Pipeline Management in the guidance and in the Internal Control Questionnaire).
10. Reporting and Analytics
   a. Ascertain if the institution's risk-management framework includes an intensive and frequent review and monitoring process.
   b. Establish whether management receives comprehensive reports about the characteristics and trends of the institution's leveraged lending portfolio at least quarterly and if summaries are provided to the board of directors.
   c. Find out if internal reports provide a detailed and comprehensive view of global exposures, including situations when an institution has an indirect exposure to an obligor or is holding a previously sold position as collateral or as a reference asset in a derivative. Borrower and counterparty leveraged lending reporting should aggregate total exposure and consider exposures booked across business lines or legal entities.
   d. Verify that internal policies identify the data fields to be populated and captured by the institution's MIS and whether the reports are accurate, timely, and if the information is provided to management and the board of directors.
   e. Confirm that MIS reporting on the leveraged lending portfolio contains the applicable measures listed in the guidance. (Refer to the section on Reporting and

Analytics in the guidance and in the Internal Control Questionnaire.)

11. Credit Analysis
    a. Conduct transaction testing on individual leveraged lending credits to determine if the credit analysis contains a comprehensive assessment of financial, business, and industry and management risks.
    b. Evaluate individual credits to determine if they fit the institutions definition of a leveraged loan.
    c. Determine if individual credits were analyzed in conjunction with the parameters in the guidance. (Refer to the section on Credit Analysis in the guidance and in the Internal Control Questionnaire.)
    d. Verify that there are guidelines for evaluating deal sponsors and their willingness and ability to support the credit.
    e. Confirm that sponsors are used as a secondary and not a primary source of repayment.
    f. Assess the credit agreement to determine if it contains language for:
       - Material dilution, sale, or exchange of collateral or cash flow producing assets without lender approval.
       - Financial performance covenants; covenant-lite, and payment-in-kind (PIK) toggle loan structures.
       - Reporting requirements and compliance monitoring.
       - The distribution of reporting and other credit information to participants and investors.
       - Acceptable collateral types, loan to value guidelines and appropriate collateral valuation methodologies.
12. Internal Risk Rating
    a. Determine if individual loans are risk rated based on the borrower's demonstrated ability to repay the loan and de-lever over a reasonable period of time.
       - Confirm that the institution has evidence of adequate repayment capacity, for example borrowers demonstrate the ability to fully amortize senior debt or repay at least 50 percent of total debt over a 5–7 year period. Ensure that extensions or other restructuring are not masking an inability to repay.
       - Consider adversely rating credits that do not show the capacity to pay down debt from cash flow or if refinancing is the only option for repayment.
       - Consider a substandard rating if there are no reasonable or realistic prospects for repayment or de-levering.
13. Deal Sponsors
    a. If a deal sponsor is relied on as a secondary source of repayment, determine if management has developed guidelines for evaluating the sponsor's creditworthiness.
    b. Evaluate the sponsor based on the criteria listed in the guidance. (See the section on Deal Sponsors in the guidance and in the Internal Control Questionnaire).
14. Credit Review/Problem Credit Management
    a. Assess credit review staff's expertise relative to leveraged lending.
    b. Verify that the institution conducts frequent internal credit review of leveraged lending portfolio that is done independently of the origination function. Portfolio reviews should generally be conducted no less than annually.
    c. Evaluate the institution's procedures for dealing with problem credits including if work out plans contain quantifiable objectives and measurable time frames.
15. Stress Testing
    a. Determine if the institution has developed stress tests for leveraged loans or if the loans are included in the existing stress testing protocol.
16. Conflicts of Interest/Reputational Risk/Compliance
    a. Confirm that the institution is meeting its legal responsibilities by underwriting and distributing transactions that do not result in undue reputational risk.
    b. Determine if potential conflicts of interest exist if the institution has both equity and lending positions in a particular transaction. Confirm that policies and procedures are in place to handle conflicts of interest.
    c. Ascertain whether the institution's compliance function periodically reviews the institution's leveraged lending activity.
    d. Ascertain whether the institution's policies incorporate safeguards to prevent violations of anti-tying regulations.
    e. When securities are involved, determine how the institution ensures compliance

with applicable securities laws, including disclosure and other regulatory requirements.

f. Ascertain what plans and provisions have been developed to ensure compliance with the Board's Regulation W (12 CFR part 223).

Applicability/Risk-Management Framework

1. Has the institution adopted a risk-management framework around leveraged lending that includes:
   a. A leveraged lending policy that is based on risk objectives, risk acceptance criteria, and risk controls?
   b. Structuring transactions that reflect a sound business premise, have an appropriate capital structure, reasonable cash flow, and balance sheet leverage?
   c. A definition of leveraged lending that can be applied across all business lines?
   d. Well-defined underwriting standards that define acceptable leverage levels and amortization expectations?
   e. A limit framework?
   f. Sound MIS?
   g. Pipeline management procedures, hold limits, and expected timing for distributions?
   h. Guidelines for stress testing?
2. Is the institution able to identify leveraged exposures to related borrowers or guarantors?
3. Is the institution able to identify leveraged loans that are managed in non-lending portfolios (for example collateralized loan obligations (CLOs), special purpose entities (SPEs), or other indirect exposures)?
4. Is the institution originating leveraged loans, participating in leveraged loans, or both?

Definition of Leveraged Lending

1. Has the institution developed an appropriate written definition for leveraged lending and incorporated it into the leveraged lending policy?
2. Is the policy definition consistent with the amounts and types of leveraged loans that the institution is engaged in?

General Policy Expectations

1. Has the institution's leveraged lending policy been approved by the board of directors?
2. Does the leveraged lending policy contain the following elements:
   a. A clear statement of the amounts of leveraged lending that it is willing to underwrite and the amount(s) it is willing to hold in its own portfolio?
   b. A limit framework that establishes limits or guidelines around the following as applicable:
      1) Single obligors and transactions?
      2) Aggregate hold portfolio?
      3) Total pipeline exposure?
      4) Industry and geographic concentration?
      5) Notional pipeline limits?
      6) Stress losses, flex terms, economic capital usage, and earnings at risk?
      7) Other parameters particular to the portfolio?
      8) The required management approval authorities and exception tracking provisions?
   c. Procedures for insuring that leveraged lending risks are appropriately reflected in the institution's level of allowance for loan and lease losses (ALLL) and capital adequacy analysis?
   d. Credit and underwriting approval authorities, including the procedures for approving and documenting changes to approved transaction structures and terms?
   e. Guidelines for appropriate oversight by senior management, including adequate and timely reporting to the board of directors?
   f. Expected risk-adjusted returns for leveraged transactions?
   g. Minimum underwriting standards and underwriting practices for primary loan origination and secondary loan acquisition?

Participations Purchased

1. Has the institution, with respect to participations purchased, done its own independent underwriting of its portion of the transaction and has it adequately identified its risks?

2. Has the institution received copies of all documentation relevant to the transaction?
3. Is there evidence that the institution has reviewed the participation agreement and has a clear understanding of its rights and responsibilities under the agreement?

Underwriting Standards

1. Is the institution using similar underwriting standards for leveraged loans it plans to hold as well as for leveraged loans it plans to distribute?
2. Are the institution's underwriting standards clear, written, and measurable?
3. Do underwriting standards require:
   - A sound business premise for each transaction and that the borrower's capital structure is sustainable?
   - A determination and documentation of the borrower's capacity to repay and ability to de-lever to a sustainable level over a reasonable period?
   - Standards for evaluating various types of collateral?
   - Standards for evaluating risk-adjusted returns?
   - The acceptable degree of reliance on enterprise value and other intangible assets for loan repayment?
   - Expectations for the degree of support expected to be provided by sponsors?
   - A prohibition on material dilution, sale, or exchange of collateral or cash flow producing assets without lender approval?
   - A credit agreement that contains financial covenants, reporting covenants, and compliance monitoring? Does the loan contain covenant-lite and PIK toggle loan structures? If so, does the borrower have the ability to repay the loan under the contractual terms?
   - Guidelines for acceptable collateral types, loan-to value-guidelines, and acceptable collateral valuation methodologies?
   - Loan agreements that provide for the distribution of financial information to participants and investors?

Valuation Standards

1. Does the institution have policies for valuing illiquid, intangible, or hard to value collateral that include appropriate LTV ratios, discount rates, and collateral margins?
2. Is the institution relying on enterprise value to confirm a secondary source of repayment?
   a. Has the institution documented its valuation approach to calculating enterprise value?
   b. Has the valuation been performed by qualified persons independent of the origination function?
   c. Has one or a combination of three methods been used for determining enterprise value, asset valuation, income valuation, or market valuation?
   d. If the income method is used, is it based on capitalized cash flow or discounted cash flow?
   e. Has the institution confirmed proxy measures such as multiples of cash flow earnings or sales by performing its own discounted cash flow analysis?
   f. Are stress tests of key variables and assumptions used in determining enterprise value (such as cash flow earnings and sales multiples) conducted at origination and periodically thereafter?
   g. Does the institution have established limits for the proportion of individual transactions and the total portfolio that are supported by enterprise value?

Pipeline Management

1. Do strong risk-management controls cover all transactions in the pipeline, including amounts planned for hold and those marked for distribution?
2. Does the institution have the capability to differentiate transactions based on their key characteristics, tenor, and investor class (pro-rata and institutional), structure, and key borrower characteristics (for example, industry)?
3. Does the institution have the following controls for pipeline exposure:
   - A documented appetite for underwriting pipeline risk that considers the potential effects on earnings, capital, and liquidity?
   - Written policies and procedures for "hung deals" or deals that are not sold

down within a reasonable or 90-day period?
  – Have transactions reclassified as hold-to-maturity been reported to management and the board of directors?
- Guidelines for conducting periodic stress tests of pipeline exposures?
- Controls to monitor expected vs. actual performance?
- Reports that show individual and aggregate transaction information, risk ratings and concentrations?
- Limits on hold levels per borrower, counterparty, and aggregate hold levels?
- Limits on the amounts intended for distribution?
- Policies and procedures for acceptable accounting methods, including prompt recognition of losses?
- Policies and procedures around acceptable hedging practices if applicable?
- Plans to address contingent liabilities and compliance with Sections 23A and 23B of the Federal Reserve Act and Regulation W?

Reporting and Analytics

1. Does management receive quarterly comprehensive reports about the characteristics and trends of the institution's leveraged lending portfolio? Are summaries provided to the board of directors?
2. Do internal policies identify the data fields to be populated and captured by the institution's MIS? Are the reports accurate and timely?
3. As dictated by the size and complexity of the leveraged lending portfolio, does MIS reporting on the leveraged lending portfolio include the following:
   a. Individual and portfolio exposures within and across all business lines and legal vehicles including the pipeline?
   b. Risk-rating distribution and migration analysis?
   c. A list of borrowers who have been removed from the leveraged lending portfolio due to improvements in their financial characteristics and risk profile? Is the removal from the profile concurrent with a refinance, restructure or some other modification in the loan agreement?
   d. Industry mix and maturity profile?
   e. Metrics derived from probability of default and loss-given default?
   f. Portfolio performance measures including covenant breaches, restructurings, delinquencies, nonperforming asset amounts, and charge offs?
   g. Amount and nature of impaired assets and the amount of ALLL attributable to leveraged lending?
   h. The level of policy exceptions in the portfolio?
   i. Exposures by collateral type, including unsecured transactions when enterprise values will be the only source of repayment?
   j. Defaults that trigger *pari-passu* treatment for all lenders?
   k. Secondary market pricing data and trading volume (when available)?
   l. An aggregation of exposures by and performance of deal sponsors?
   m. An indication of gross and net exposures, hedge and counterparty concentrations; and indication of policy exceptions?
   n. Actual vs. projected distribution levels of the pipeline with reports of excess levels of exposure over hold targets?
   o. *Types of exposure in the pipeline:* committed exposures not accepted by the borrower; exposures committed and accepted but not closed; funded and unfunded commitments closed but not distributed?
   p. *Total and segmented exposures:* subordinated debt and equity holdings (compared to limits); global exposures; indirect exposure (to an obligor or if the institution is holding a previously sold position as collateral or as a reference asset in a derivative)?
   q. Exposures booked in other business units throughout the institution that are related to a leveraged loan or borrower? (For example, default swaps or total return swaps naming the distributed paper as a covered or referenced asset or as collateral exposure through repo transactions).
   r. Positions held in leveraged loans in available for sale or traded portfolios or held in structured-investment vehicles owned or operated by the originating institution or its subsidiaries or affiliates?

Internal Risk Rating

1. Does the institution have evidence of adequate repayment capacity? For example, do borrowers demonstrate the ability to fully amortize senior debt or repay at least 50 percent of total debt over a five- to seven-year period?
2. Are there extensions or other restructuring that are masking an inability to repay?
3. Has the primary source of repayment become inadequate? Is enterprise value being relied on as a secondary source of repayment? Is enterprise value well supported with binding purchase and sale agreements with qualified third parties? Does enterprise value consider the borrower's distressed circumstances?

Credit Analysis

1. Does transaction testing of individual leveraged lending credits contain the following elements and show that:
   a. *Cash flow analysis*—The analysis does not rely on overly optimistic or unsubstantiated projections of sales, margins, or merger and acquisition synergies?
   b. *Liquidity analysis*—There are measures to determine operating cash needs and cash needed to meet debt maturities? Analyze liquidity based on industry performance metrics?
   c. *Projections*—There is adequate margin for unanticipated merger-related integration costs?
   d. *Stress tests*—Projections are stress tested for one or more downside scenarios, including a covenant breach?
   e. *Variances from plan*—Transactions are reviewed at least quarterly to determine variance from plan; does the credit file contain a chronological rationale for and analysis of all changes to the operating plan and variances from the expected financial performance?
   f. *Enterprise value*—Were enterprise values independently derived and validated outside of the origination function? Were values calculated timely and did they consider value erosion?
   g. *Collateral shortfalls*—Have shortfalls been identified and factored into the risk rating?
   h. *Collateral liquidation and asset sales*—Are any liquidations and sales based on current market conditions and trends?
   i. *Contingency plans*—Are there contingency analyses to anticipate changing conditions in debt or equity markets? Do the exposures rely on refinancing or the issuance of new equity?
   j. *Interest rate risk and foreign exchange risk*—Have these risks been addressed in the analysis? Are mitigants in place?

Problem Credit Management

1. Has the institution formulated and established procedures for dealing with problem credits?
2. Do work out plans contain quantifiable objectives and measurable time frames?
3. Are problem credits regularly reviewed for risk-rating accuracy, accrual status, recognition of impairment through specific allocations and charge-offs.

Deal Sponsors

1. Has the institution developed guidelines for evaluating the willingness and ability of sponsors to support the credit exposure and a process to regularly monitor sponsor performance?
2. Determine if the credit analysis has considered:
   a. If the sponsor is relied on as a secondary source of repayment and not a primary source of repayment?
   b. If the sponsor has a historical pattern of supporting investments, financially or otherwise?
   c. If the degree of support has been documented via a guarantee, comfort level, or verbal assurance?
   d. If there has been a periodic review of the sponsor's financial statements, an analysis of liquidity, and an analysis of the sponsor's ability to support multiple deals?
   e. If consideration has been given to the sponsor's dividend and capital contribution practices and the likelihood that the sponsor will support the borrower as compared to other deals in the sponsor's portfolio?

Credit Review

1. Does the institution conduct an internal credit review of the leveraged lending portfolio regularly, but at least once per year?
2. Does the institution ensure that credit review personnel have the knowledge and ability to identify risks in the leveraged lending portfolio?

Stress Testing

1. Has the institution developed and implemented guidelines for conducting periodic portfolio stress tests on loans originated to hold and on loans originated to distribute?
2. Has the institution conducted periodic loan and leveraged lending portfolio level stress tests?
3. If applicable, has the leveraged lending portfolio been included in enterprise wide stress tests?
4. Does stress testing of leveraged credits include sensitivity analyses to quantify the potential impact of changing economic and market conditions on the institution's asset quality, earnings, liquidity, and capital?

Reputational Risk

1. Does the institution have procedures, safeguards, actions, training, and staff reminders about the potential reputational risk associated with poorly underwritten originated leveraged loans?
2. Has there been any failure or apparent failure by the institution to meet its legal responsibilities in underwriting and distributing transactions that could damage its reputation or its ability to compete?

Conflicts of Interest

1. Has the institution developed appropriate policies and procedures to address and to prevent potential conflicts of interest when it has both equity and lending positions?
2. Do policies and procedures:
   a. Clearly define potential conflicts of interest?
   b. Identify appropriate risk-management controls and procedures?
   c. Enable employees to report potential conflicts of interest to managements without fear of retribution?
   d. Ensure compliance with applicable laws?
3. Has management:
   a. Established a training program for employees on appropriate practices to follow to avoid conflicts of interest?
   b. Provided for reporting, tracking, and resolution of any conflicts?

Compliance

1. Does the institution maintain an independent compliance review function to periodically review its leveraged lending activity?
2. Do the institution's policies include safeguards to prevent violations of anti-tying regulations?
3. How does the institution ensure compliance with applicable securities laws, including disclosure and other regulatory requirements when equity interests and certain debt instruments have been used in leveraged transactions that may constitute "securities" under federal securities laws?
4. Have plans and provisions been developed to ensure compliance with sections 23A and 23B of the Federal Reserve Act and Regulation W?

INTRODUCTION

A direct financing lease is one in which the lessor's only source of revenue is interest. The lessor buys an asset and leases it to the lessee. This transaction is an alternative to the more customary lending arrangement in which a borrower uses the loan proceeds to purchase an asset. A direct financing lease is the functional equivalent of a loan.

Leasing is a recognized form of financing that provides a lessee (the customer) the right to use depreciable assets without tying up working capital. Leasing frequently offers the lessee greater flexibility than traditional bank term-loan financing. Leasing also provides the lessor (the owner of the asset) with a generally higher rate of return than lending, but this is in exchange for assuming greater risk or investing more resources in marketing and deal structuring. The higher risk inherent in a typical lease transaction is due to the higher advance to collateral value; a longer payment period; and, in some cases, the lessor's dependence on the sale of the leased property to recover a portion of the capital investment. In most instances, some or all of the higher rate of return for the lessor is derived from the tax benefits of depreciable asset ownership.

While leases differ from loans in some respects, they are similar from a credit viewpoint because the basic considerations are cash flow, repayment capacity, credit history, management, and projections of future operations. Additional considerations are the type of property being leased and its marketability in the event of default or termination of the lease. However, these latter considerations do not radically alter how an examiner evaluates collateral for a lease. The assumption is that the lessee/borrower will generate sufficient funds to liquidate the lease/debt. Leases are generally structured so that the bank recovers the full cost of the equipment plus an interest factor over the course of the lease term. Sale of the leased property/collateral remains a secondary source of repayment and, except for the estimated residual value at the expiration of the lease, will not, in most cases, become a factor in liquidating the advance.

In general, leasing activities of state member banks are governed by federal tax law and applicable state law. The leasing of personal or real property or acting as agent, broker, or adviser in leasing such property is considered a "closely related nonbanking activity" and is therefore permitted in accordance with the requirements of section 225.28(b)(3) of Regulation Y for a bank holding company (BHC) or subsidiary thereof. While not specifically applicable to banks, these Regulation Y requirements provide useful guidelines for reviewing the appropriateness and prudence of bank leasing activities as well as considering any safety-and-soundness implications.

A BHC can act as an agent, broker, or adviser in leasing personal or real property only if—

- the lease is on a nonoperating basis[1] and
- the initial term of the lease is at least 90 days.

For leases involving real property—

- the effect of the transaction at the inception of the initial lease must be to yield a return that will compensate the lessor for not less than the lessor's full investment in the property plus the estimated total cost of financing the property over the term of the lease, such return to be derived from rental payments, estimated tax benefits, and the estimated residual value of the property at the expiration of the initial lease; and
- the estimated residual value cannot exceed 25 percent of the acquisition cost of the property to the lessor.[2]

1. With respect to the "nonoperating basis" requirement, a BHC may not, directly or indirectly, engage in operating, servicing, maintaining, or repairing leased property during the term of the lease. For automobile leasing, this requirement means that a BHC may not, directly or indirectly, (1) provide servicing, repair, or maintenance of the leased vehicle during the lease term; (2) purchase parts and accessories in bulk or for an individual vehicle after the lessee has taken delivery of the vehicle; (3) provide the loan of an automobile during servicing of the leased vehicle; (4) purchase insurance for the lessee; or (5) provide for the renewal of the vehicle's license merely as a service to the lessee when the lessee could renew the license without authorization from the lessor. The BHC can arrange for a third party to provide these services or products.

2. For more information, see the *Bank Holding Company Supervision Manual* section entitled "Section 4(c)(8) of the BHC Act (Leasing Personal or Real Property)."

ACCOUNTING FOR DIRECT FINANCING LEASES

Leases should be accounted for in accordance with accounting standards issued by the Financial Accounting Standards Board (FASB). The lease accounting standard currently applied by public business entities, "Leases (Topic 842)," was issued by the FASB in February 2016, and will fully supersede ASC Topic 840, "Leases," by 2021.[3] In addition, more specific information on the capitalization of leases is provided in ASC Topic 840, "Accounting for Direct Financing Leases." The Consolidated Reports of Condition and Income (Call Report) and related instructions provide more information on the capitalization of leases and specify regulatory reporting requirements for leases.

Lessors employ a variety of methods to account for their investments in leases. A direct financing lease is a type of capital lease that transfers substantially all the benefits and risks inherent in the ownership of the leased property to the lessee. In addition, collection of the minimum lease payments must be reasonably predictable, and no important uncertainties may exist regarding costs to be incurred by the lessor under the terms of the lease. Although minor variations in accounting methods are still found, most investment-in-leases accounts will be equal to—

- the sum of the minimum lease payments to be received from the lessee, plus
- the unguaranteed residual value (estimated fair market value) of the property at the end of the lease term, reduced by
- the amount of unearned and deferred income to be recognized over the life of the lease.

For the purpose of illustration, assume that property costing $120,000 is leased for a period of 96 months at $1,605 per month, and the estimated residual value (ERV) of the property is $24,000. In this example, income is recognized monthly according to the sum of the months' digits method. The investment in this lease is calculated below, followed by an explanation of each component of the net investment.

Cost	$120,000
Unearned income	34,080
Rentals receivable (96 × $1,605)	154,080
Est. residual value	24,000
Gross investment	178,080
Less:	
Unearned income	34,080
Unearned income (ERV)	24,000
Net investment	120,000

Rentals Receivable

This account is established in the amount of total rental payments to be received from the lessee. The amount by which the rentals receivable ($154,080) exceeds the cost of the property ($120,000) is the functional equivalent of interest and represents a portion of the income to be recognized over the life of the lease. In the example below, the cost of the property is temporarily charged to a fixed-asset account, then transferred to rentals receivable.

Fixed assets	$120,000	
Cash		120,000
To record purchase or property for lease		
Rentals receivable	154,080	
Fixed assets		120,000
Unearned income		34,080
To record amount due from lessee		

3. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for banks that are public business entities (PBEs). For banks that are not PBEs, the guidance is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For further information, see the Glossary entries in the Call Report Instructions for "public business entity" and "private company." Early adoption is permitted for all banks. An institution that early adopts these standards must apply them in their entirety. If an institution chooses to early adopt these standards for financial reporting purposes, the institution should implement them in its Call Report for the same quarter-end report date.

Throughout the lease term, the rentals-receivable account is periodically reduced by the full amount of each rental payment received.

Cash	$1,605	
Rentals receivable		1,605
To record receipt of monthly payment		

Estimated Residual Value

The ERV represents the proceeds the lessor expects to realize at the end of the lease term from the sale or re-leasing of the property. Exactly as its title states, this account represents only an estimate of future value and does not represent current market value or depreciated book value. The residual value at the end of the lease term is considered to be income, and the corresponding credit for this asset account is posted to unearned income.

The balance of the ERV account does not normally change significantly during the lease term. The bank (lessor) should review the unguaranteed residual value at least annually to determine whether a decline, other than a temporary one, has occurred in its estimated value. If a decline is not temporary, the accounting for the lease transaction should be revised using the new estimate, and the resulting loss should be recognized in the period that the change is made. Upward adjustments or increases in the residual value are not recognized.

After the end of the term, the residual value account is eliminated from the books upon sale, re-lease, or other disposition of the property. If the amount of proceeds received differs from the recorded residual value, the difference will be recognized as either a gain or loss, whichever is appropriate.

Est. residual value	$24,000	
Unearned income		24,000
To record ERV of leased property		
Cash	26,000	
Est. residual value		24,000
Gain on sale		2,000
To record sale of property		

Any portion of the ERV guaranteed by a party unrelated to the lessor would be deducted from the ERV account and added to rentals receivable.

Unearned Income

This liability account has a credit balance and is netted against the total of rentals receivable and the ERV for balance-sheet presentation. Its component parts are the “interest” income equal to the excess of rentals receivable over the cost of the property and the income to be realized from disposition of the property at the end of the lease term. Each of these components is recognized as income throughout the life of the lease by periodic transfers to earned income. Unearned income is amortized to income over the lease term to produce a constant periodic rate of return on the net investment in the lease. Any other method, such as the sum-of-the-months’-digits method, may be used if the results obtained are not materially different from those that would result from the interest method described in the preceding sentence and if the resulting impact does not overstate income during the current period. Loan-origination fees and initial direct costs, such as commissions and fees that are incurred by the lessor in negotiating and consummating the lease, are offset against each other, and the resulting net amount is deferred and recognized over the lease term. Recognizing a portion of the unearned income at the inception of the lease to offset initial direct costs is not acceptable.

Depreciation

For certain leases, the lessor is entitled to claim depreciation for tax purposes. However, for financial statement purposes, no depreciation for leased property will appear on the income statement and no accumulated depreciation will appear on the balance sheet. If the lessor is entitled to the benefits of depreciation, then, for tax purposes only, depreciation will be calculated and will reduce the lessor’s tax liability.

The lessor’s entitlement to depreciation tax benefits is a function of the type of lease arrangement negotiated. When the lessor retains title to the asset and owns the asset at the expiration of the lease, the lessor may take depreciation into account for tax purposes. These characteristics are typical of a "true," "net," or "capital" lease, terms often used interchangeably in the industry. In a "financing" lease, the lessee rather than the lessor acquires title to the property at the expiration of the lease and is entitled to depreciation tax benefits. Accordingly, the lessor will charge the lessee a higher periodic lease payment (for a higher "rate of return") to offset its loss of depreciation tax benefits.

Balance-Sheet Presentation

Lease receivables are to be reported on the balance sheet as the single amount "net investment" (see below). If the lessor has established an allowance for possible lease losses, this amount is included in the total allowance for loan and lease losses and represents a deduction from the net investment. Footnotes to the balance sheet should disclose the components of the net investment, as follows:

Rentals receivable	$154,080
Est. residual value	24,000
Gross investment	178,080
Less:	
Unearned income	58,080
Net investment	$120,000

For Call Report purposes, lease financing receivables are reported net of unearned income as part of an institution's total loans.

Classification

If it is deemed appropriate to classify a lease, the amount at which the lease would be classified is the net investment. For example, assume that 94 of the 96 payments have been received on the above lease, that income has been recognized monthly according to the sum-of-the-months'-digits method, and that the lease is now considered a loss. Its balance on the books is $27,173, as follows:

Rentals receivable	$ 3,210
Est. residual value	24,000
Gross investment	27,210
Less:	
Unearned income	22
Unearned income (ERV)	15
Net investment	27,173

Classification of the $27,173 balance of this lease involves classifying $3,188 of the unrecovered portion of the cost of the property ($3,210 less $22 unearned income) plus $23,985 of income that has already been recognized in anticipation of receiving the ERV ($24,000 less $15 not yet recognized). In short, the calculation is $3,188 + $23,985 = $27,173.

Charging off the ERV included in the net investment treats the lease as if the underlying property has no value and, in effect, reverses the unearned income that has been recognized in anticipation of selling the leased property at its recorded ERV. Accordingly, if the property does have value, the $27,173 classified should be reduced by the net amount that the lessor could realize by selling the property.

Delinquency

The percentage of delinquency in the lease portfolio is calculated by dividing the aggregate rentals receivable on delinquent leases (less the "interest" components of their unearned income accounts) by the total of rentals receivable on all leases (less the "interest" components of their unearned income accounts). ERVs would not be included in the delinquent amounts since they do not represent obligations of the lessees.[4]

If the lease obligation in the previously described classification example was the only delinquent obligation in a portfolio of leases with component accounts as shown below, the rate of delinquency in the portfolio would be 3.4 percent.

4. For more information on reporting delinquent leases in the report of examination, see section 1001.1, "Community Bank Supervision Process."

Rentals receivable	$ 94,411
Est. residual value	705,882
Gross investment	800,293
Less:	
Unearned income	647
Unearned income (ERV)	441
Net investment	$799,205

$$\frac{\$3{,}210 - 22}{\$94{,}411 - 647} = 3.4\%$$

Termination of a Lease

The termination of a lease is recognized in the income of the period in which the termination occurs by eliminating the remaining net investment from the lessor's account. The lease property is then recorded as an asset using the lower of the original cost, present fair value, or present carrying amount.

LEVERAGED LEASES

Leveraged leasing is a specialized form of direct financing lease that involves at least three parties: a lessee, a long-term creditor (the debt participant), and a lessor (the equity participant). This type of lease transaction is complex because it usually involves a large dollar amount, a significant number of parties, complex legal issues, and the unique advantages to all parties. In a leveraged lease, the lessor purchases and becomes owner of the equipment by providing only a percentage (usually 20 to 40 percent) of the capital needed. The rest of the purchase price is borrowed by the lessor from long-term lenders on a nonrecourse basis. The borrowings are secured by a first lien on the equipment, an assignment of the lease, and an assignment of the lease payments.

Legal expenses and administrative costs associated with leveraged leasing limit its use to financing large capital-equipment projects. Leveraged leases are generally used to take advantage of favorable tax benefits unique to this type of financing for the participants in the transaction. By tailoring the tax effects to the needs of the parties involved, the structure of a leveraged lease permits multiple tax benefits and maximum investment return. The lessor is in search of a tax shelter to offset income generated from other sources, while the lessee bargains for lower rental charges in exchange for the tax advantage the lessor receives. The result of this trade-off ideally produces an attractive rate of return on the lessor's invested dollars, while the lessee conserves working capital and obtains financing at a cost substantially below the lessee's usual borrowing rate.

If the equipment being purchased is costly, such as heavy construction equipment or a fleet of airplanes, there may be several equity owners and debtholders involved. In this case, an owner trustee may be named to hold title to the equipment and to represent the equity owners. An indenture trustee may be named to hold the chattel mortgage on the property for the benefit of the debtholders.

The lessor (equity holder), as the owner, is allowed to take accelerated depreciation based on the total cost of the equipment. The lessor might also receive a small portion of the rental payments, but the desired yield is obtained from the timing of depreciation. The effect gives the lessor a return through the tax benefits and a small amount of rental income and allows the lessor to retain the residual value rights to the equipment at the end of the lease period.

The bank should consider its present and anticipated future tax position, its future money rates, and the residual value of the property. The return on the bank's investment in leveraged leases depends largely on these factors. A slight change can precipitate significant changes in the bank's position. Anticipated proceeds from the sale or re-leasing of the property at the conclusion of the lease term (the residual value) is an important element of the return and should be estimated carefully. It will, in most cases, exceed 25 percent of the purchase price because of certain tax requirements. The bank should continually evaluate the property for misuse, obsolescence, or market decline, all of which can rapidly deteriorate the value of the property before the lease term expires. In these cases, the lessee may default, often with expensive consequences for the lessors.

A portion of the bank's recapture of its investment in leased property is often predicated on the inherent tax benefits. Accordingly, a decline in the bank's ability to use these tax benefits could reduce or eliminate the profitability of the venture.

Given the complexity of leveraged leasing it is important to carefully scrutinize each indenture and all parties involved in the leveraged leasing transaction. It is important to consider each lease from the standpoint of the creditworthiness of the lessee and the assessed value of the leased property. If the lessee defaults, the loan participant is in a position to foreclose and take ownership of the property, which leaves the bank without a way to recapture the carrying value of its investment. Therefore, in assessing the credit risk of a leveraged lease transaction, a bank should evaluate the business risk associated with the lease's operating cash flows.

The lessor's net investment in a leveraged lease is recorded in a manner similar to that for a direct financing lease, but net of the principal and interest on the nonrecourse debt. The components of the net investment, including related deferred taxes, should be fully disclosed in the footnotes to the lessor's financial statements when leveraged leasing is a significant part of a bank's business activities.

ASC 840 provides guidance on how to account for a leveraged lease. In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842)," which supersedes ASC 840. Leases classified as leveraged leases prior to the adoption of Topic 842 may continue to be accounted for under Topic 840 unless subsequently modified. Topic 842 eliminates leveraged lease accounting for leases that commence after an institution adopts the new accounting standard.

POLICY CONSIDERATIONS

1. Assess the adequacy of leasing policies, procedures, and practices by considering
   - the frequency and timeliness of policy reviews and updates by the board of directors;
   - whether policies address
     - — acceptable product lines and asset acquisition practices;
     - — pre-approval and on-going reviews of equipment vendors and lease brokers;
     - — prudent underwriting standards;
     - — securitization of leases (if applicable);
     - — minimum down payments or deposits for each type of equipment or auto leased;
     - — documentation required for each type of equipment lease;
     - — appraisals of equipment and procedures for selecting appraisers;
     - — the control, maintenance, insurance, and disposition of asset inventories;
     - — the review of completed lease documents by legal counsel, including tax opinions;
     - — the allowable percentage of leasing components (financing amount and recapture of residual value in relation to the total cash flows); and
     - — the methodology for determining the allowance for loan and lease losses on lease receivables and ensuring it is appropriate under ASC Subtopic 450-20, "Contingencies—Loss Contingencies"; and
   - whether management established appropriate guidelines for
     - — establishing estimated residual values, periodic re-evaluations, and periodic portfolio impairment analysis of leased assets;
     - — establishing mark-to-market values and associated accounting procedures if assets leased on operating terms are periodically marked to market to mitigate end-of-lease residual risks;
     - — pre-purchase analysis of assets leased on operating terms. (This is particularly important for long-lived assets, which can have multi-year delays in delivery, underutilization risks, and high carrying costs);
     - — limits on concentration risks by industry, lease broker, and equipment type;
     - — limits on leveraged leases where the bank takes an equity position; and
     - — managing differences in book and tax accounting (deferred tax assets/liabilities). (Note: Banks commonly classify the same lease as a capital lease for regulatory reporting purposes, which requires allowance for loan and lease losses (ALLL) treatment, and as an operating lease for tax reporting purposes, which allows the bank to depreciate the underlying fixed asset according to an accelerated depreciation schedule, thus reducing the overall tax liability.)

DOCUMENTATION

2. Review a sample of lease files to determine if they are properly documented. In addition to the standard documentation required for other types of lending (such as credit applications and credit reports), the following documents unique to lease financing should be in the file, particularly for larger leases:
   - master lease agreement
   - lease schedule
   - lessee's resolution
   - lessee's acceptance form
   - purchase order and purchase order requirement
   - standard UCC-1 filing
   - inspection reports post installation (expected on larger leases)

ADMINISTRATION

3. Determine whether the bank has appropriate insurance on leased assets identified as having potential liability. (Note: As owner of the equipment being leased, the bank may be liable for claims in the event of an accident involving the equipment.)
4. Review asset acquisition and disposition records to ascertain if any conflict of interest or self-dealing is evident involving insid-

ers, sellers, servicers, insurers, or purchasers of equipment.

5. Determine whether property held in inventory, designated as to-be-sold or leased again, is appropriately accounted for, maintained, and controlled. Consider if any assets held in this category warrant classification.
6. Review the bank's methodology for assigning estimated residual values and performing annual re-evaluations. ASC Paragraph 840-30-35-25, "Leases: Capital Leases—Subsequent Measurement – Estimated Residual Value" requires the lessor to review estimated residual values at least annually. If a decline in an estimated residual value is judged to be other than temporary, the bank shall account for the decline as a change in estimate, and charge a period loss in earnings for the reduction in the net investment of the lease. Banks should not make provisions to the ALLL to account for declines in estimated residual values. (Note: Inflated residual values could indicate the bank is aggressively pricing its leases. While the reduced lease payments may be attractive to the lessee, residual losses could increase for the lessor.)
7. Determine whether management has an effective system for tracking residual gains and losses. (Note: Increasing residual losses may be a sign that pricing competition contributed to inflated residual values. Institutions often use a termination report that reflects all the relevant information concerning leases that have or will soon mature. Check appropriate state laws for determining how long leased assets may be held on the bank's books before disposition.)
8. Determine whether leases meet one or more of the criteria for capital leases plus two additional criteria at the inception of the lease. (Note: If a lease is not accounted for as a direct financing lease, sales-type lease, or leveraged lease, refer to the Consolidated Report of Condition and Income (Call Report) instructions concerning operating leases.)
   - A lease is accounted for as a capitalized lease if any one of the following criteria is met:
     - — Ownership of the property is transferred to the lessee by the end of the lease term.
     - — The lease contains a bargain purchase option.
     - — The lease term represents at least 75 percent of the estimated economic life of the leased property.
     - — The present value of the minimum lease payments at the beginning of the lease is at least 90 percent of the fair value of the leased property.
   - Does the lease meet one or more of the capital lease criteria? If the answer is no, the lease is an operating lease. If the answer is yes, does the lease meet both of the following two criteria?
     - — Collectability of minimum lease payments is reasonably predictable.
     - — No important uncertainties surround the amount of un-reimbursable costs yet to be incurred by the lessor under the lease.

     If the answers are yes, the lease is a capital lease and must be classified as either a sales-type lease, direct financing lease, or a leveraged lease.
   - Does the lease give rise to manufacturer's or dealer's profit? If the answer is no, the lease is either a direct financing or leveraged lease. If the answer is yes, the lease is a sales-type lease. (Note: Leveraged leases are a form of direct financing lease that involves at least three parties, a lessee, a long-term creditor, and a lessor or equity participant. The financing provided by the long-term creditor is nonrecourse as to the general credit of the lessor. The lessor's net investment declines during the early years once the investment has been completed and rises during the later years of the lease before its final elimination.)
9. Based on the criteria above, determine if any direct financing leases are leveraged leases. If there are leveraged leases, determine whether prudent limits were established on the percentage of capital that the bank can have as an equity participant. Because of the complexity of leveraged leases, management is expected to exhibit sufficient expertise. (Note: Refer to the definition of lease accounting in the Call Report instructions for additional information.)
10. Review the lease portfolio for any concentrations, and assess the adequacy of leasing policies and practices by considering:

- concentration types, such as by equipment manufacturer, industry, lease broker, and lease product;
- the appropriateness of established risk limits;
- the adequacy of risk analysis on concentrations; and
- the sufficiency of internal reporting and board oversight.

  (Note: Significant lease concentrations should be detailed in the report of examination.)

11. Review compliance with internal lending limits and state legal lending limits. (Note: Sections 23A (12 USC 371c) and 23B (12 USC 371c-1) of the Federal Reserve Act (Regulation W) limit transactions with affiliates.)
12. Determine whether management has an effective system for tracking yields in the leasing portfolio. The yield analysis should include information on contractual lease rates, residual gains and losses, and associated tax implications.
13. Determine whether the bank's procedures require depreciation expenses on operating leases be charged at least quarterly. (Note: Operating leases do not transfer the risks and benefits of ownership to the lessee. The lessor is the owner of the property and is entitled to any tax benefits such as accelerated depreciation.)
14. Assess the appropriateness of management's reporting on delinquent and/or nonaccrual capital leases. Also, when an operating lease is past due 30 days or more, or in nonaccrual status, ensure that reporting includes operating lease payment receivables that have been recorded as other assets in the Call Report, Schedule RC, item 11.

LEASING COMPANY PARTNERSHIPS OR BROKERS—THIRD-PARTY RELATIONSHIPS

Note: Complete this section if leases are acquired through a partnership with a third party. Often banks form partnerships with independent leasing companies and fund the leasing company's originations. Refer to outstanding guidance for discussion of third-party risks (SR 13-19, "Guidance on Managing Outsourcing Risk").

15. Determine whether the bank funds leases originated by third parties. If applicable, assess the method the bank uses to fund leases originated by the third party by considering
    - the level of communication with the lessee prior to and after the lease origination;
    - the adequacy of independent credit analysis and underwriting of the proposed lease transaction; and
    - the method used by the bank to collect payments (lockbox, direct, periodic settlements with lessor, etc.).
16. Review legal agreements between the bank and the leasing company. Assess and document key items, such as lease servicing obligations, recourse provisions, remarketing of equipment at lease-end, and compliance issues.
17. Determine whether funding arrangements result in a concentration of risk for the bank. (Note: Reviewing the leasing company's financial statements may reveal whether the leasing arrangement transferred to the bank or remained with the leasing company. If the leasing arrangement remains with the leasing company, the bank's funding would likely show up as a liability (i.e., a borrowing) on the leasing company's balance sheet and be reported by the bank as a loan(s) to the leasing originator.)
18. Assess the adequacy of the bank's ongoing oversight and reporting of significant third-party funding arrangements. Consider the following:
    - financial reviews and monitoring of portfolio performance;
    - periodic independent reviews;
    - monitoring of, and reporting on, credit support provided by the leasing company (such as when the leasing company advances funds on delinquent leases or pays off the bank if a lessee's financial condition deteriorates); and
    - periodic reports provided by the leasing company on serviced assets (e.g., collection and delinquency reports).
19. Evaluate the bank's controls for and reviews of leasing companies that service assets for the bank by considering
    - the independence and qualifications of reviewers,
    - the scope of reviews,
    - the adequacy of transaction testing, and
    - the adequacy of review documentation.

CLASSIFICATION

20. Classify credits and assign allocations to the ALLL as appropriate. When evaluating the credit quality of a capital lease, consider the following:
    - the lessee's ability to properly amortize the fixed obligation;
    - the lessee's ability to pay any unamortized balance (balloon payment) at lease maturity;
    - the lessee's projected cash flows compared to its achieved operational results;
    - the reasonableness of estimated residual values and exposure to loss at the end of the lease term;
    - whether the estimated residual value was reviewed in the last 12 months;
    - support of the collateral; and
    - support by guarantors, if applicable. (Note: If the collateral is a long-lived, depreciable asset (e.g., commercial aircraft, oil/natural gas tanker, oil drilling/rigging equipment) and value erosion is uneven during the lease term, amortization should likely be accelerated to ensure that loan-to-value ratios (LTVs) remain within policy during the life of the lease. Such leases look much like mortgages on real estate with respect to the size of exposures and term; however, the collateral value is expected to erode. As such, accelerated amortization is usually necessary to keep LTVs within policy limits.)

This section applies to most types of loans found in a consumer loan department. Consumer credit, also referred to as retail credit, is defined as credit extended to individuals for household, family, and other personal expenditures, rather than credit extended for use in a business or for home purchases. Consumer credit loans are loans not ordinarily maintained by either the commercial or real estate loan departments. Consumer loans frequently make up the largest number of loans originated and serviced by the bank, but their dollar volume may be significantly less than for other types of loans. Consumer credit loans may be secured or unsecured and are usually structured with short- or medium-term maturities. Broadly defined, consumer credit includes all forms of *closed-end credit (installment credit)* and *open-end credit (revolving credit),* such as check credit and credit card plans. Consumer credit also includes loans secured by an individual's personal residence, such as home equity and home-improvement loans. Home equity loans are discussed in "Real Estate Loans," section 2090.1.

The examiner should determine the adequacy of the consumer credit department's overall policies, procedures, and credit quality. The examiner's goal should not be limited to identifying current portfolio problems but should also include identifying potential problems that may result from liberal lending policies, unfavorable trends, potentially imprudent concentrations, or nonadherence to established policies. Banks lacking written policies, or failing to implement or follow established policies effectively, should be criticized in the report of examination.

TYPES OF CONSUMER CREDIT

Installment Loans

Many traditional forms of installment credit have standard monthly payments and fixed repayment schedules of one to five years. These loans are made with either fixed or variable interest rates that are based on specific indices. Installment loans fill a variety of needs, such as financing the purchase of an automobile or household appliance, financing home improvement, or consolidating debt. These loans may be unsecured or secured by an assignment of title, as in an automobile loan, or by money in a bank account.

A bank's installment loan portfolio usually consists of a large number of small loans, each scheduled to be amortized over a specific period. Most installment loans are made for consumer purchases; however, amortizing commercial loans are sometimes placed in the installment loan portfolio to facilitate their servicing. In addition, the installment loan portfolio can consist of both loans made by the bank and loans purchased from retail merchants who originated the loans to finance the sale of goods to their customers.

Indirect Installment Loans

Indirect installment loans are also known as dealer loans, sales-finance contracts, or dealer paper. In this type of consumer credit, the bank purchases, sometimes at a discount, loans originated by retailers of consumer goods, such as a car dealer. This type of lending is called indirect lending because the dealer's customer indirectly becomes a customer of the bank.

The sales-finance contracts purchased from dealers of consumer goods are generally closed-end installment loans with a fixed rate of interest. These loans are purchased in one of three ways depending on the dealer and the circumstances of purchase:

- *Without recourse.* The bank is responsible for collecting the account, curing the delinquency, or applying the deficiency against dealer reserves or holdback accounts. The majority of sales-finance contracts with dealers are without recourse.
- *Limited recourse.* The dealer will repurchase the loan, cure the default, or replace the loan only under certain circumstances in accordance with the terms of the agreement between the bank and the dealer.
- *With recourse.* The dealer is required to repurchase the loan from the bank on demand, typically within 90 to 120 days of default.

In the case of recourse and limited-recourse loans, legal lending limitations need to be considered.

Sales-finance contracts purchased without recourse from dealers should be based on the individual's creditworthiness, *not* on the financial strength of the dealership itself. The contracts purchased should comply with the bank's loan policy for similar consumer loans. Exceptions to the bank's policies and procedures should be documented in the credit file and have the appropriate level of approval. For sales-finance contracts purchased with recourse that do not meet the bank's normal credit criteria and are purchased on the basis of the added strength of the dealer, the bank should document the minimum criteria for such loans and the specific bank-approved financial covenants with which the dealer must comply.

Check Credit and Overdraft Protection

Check credit is defined, for the purpose of this manual, as the granting of unsecured, interest-bearing revolving lines of credit to individuals or businesses. Such extensions of credit are subject to the disclosure requirements of the Truth in Lending Act (TILA). Banks provide check-credit services through overdraft protection, cash reserves, and special drafts.

The most common product is overdraft line-of-credit protection, whereby a transfer is made from a preestablished line of credit to a customer's deposit account when a check is presented that would cause the account to be overdrawn. Transfers normally are made in specific increments, up to a maximum line of credit approved by the bank.

In a cash reserve system, the customer must request that the bank transfer funds from a preestablished line of credit to his or her deposit account. To avoid overdrawing the account, the customer must request the transfer before negotiating a check against the account.

In a special draft system, the customer negotiates a special check drawn directly against a preestablished line of credit. In this method, deposit accounts are not affected.

In all three systems, the bank periodically provides its check-credit customers with a statement of account activity. Required minimum payments are computed as a fraction of the balance in the account on the cycle date and may be made by automatic charges to the deposit account.

Banks also provide credit through ad hoc and automated overdraft-protection programs. Typically, ad hoc programs involve insured depository institutions' providing discretionary coverage of customers' overdrafts on a case-by-case basis. Automated overdraft-protection programs, also referred to as *bounced-check protection* or *overdraft protection,* are credit programs increasingly offered by institutions to transaction-account (typically deposit-account) customers as an alternative to traditional check-credit and ad hoc programs for covering overdrafts.

Under both the ad hoc and automated programs, regardless of whether an overdraft is paid, institutions typically impose a fee when an overdraft occurs. This fee is referred to as a nonsufficient-funds, or NSF, fee. Unlike the discretionary ad hoc accommodation typically provided to those lacking a line of credit or other type of overdraft service (such as linked accounts), automated programs are often marketed to consumers and may give consumers the impression that the service is a guaranteed short-term credit facility. These marketed programs typically provide consumers with an express overdraft "limit" that applies to their account.

Neither the ad hoc nor the automated overdraft programs are subject to the annual percentage rate (APR) disclosure requirements of TILA. These programs are, however, subject to the disclosure requirements of the Truth in Savings Act (TISA) and Regulation DD.

The specific details of institutions' overdraft-protection programs have varied over time. The programs currently offered by institutions incorporate some or all of the following characteristics:

- Institutions inform consumers that overdraft protection is a feature of their accounts and promote consumers' use of the service. Institutions may also inform consumers of their aggregate dollar limit under the overdraft-protection program.
- Coverage is automatic for consumers who meet the institution's criteria (for example, the account has been open a certain number of days, and deposits are made regularly). Typically, the institution performs no credit underwriting.
- Overdrafts generally are paid up to the aggregate limit set by the institution for the specific class of accounts. Limits are typically $100 to $500.
- Many program disclosures state that payment of an overdraft is discretionary on the part of

the institution and may disclaim any legal obligation of the institution to pay any overdraft.

- The service may extend to check transactions as well as other transactions, such as withdrawals at automated teller machines (ATMs), transactions using debit cards, preauthorized automatic debits from a consumer's account, telephone-initiated funds transfers, and online banking transactions.
- A flat fee is charged each time the service is triggered and an overdraft item is paid. Commonly, a fee in the same amount would be charged even if the overdraft item was not paid for nonsufficient funds. A daily fee may also apply for each day the account remains overdrawn.
- Some institutions offer closed-end loans to consumers who do not bring their accounts to a positive balance within a specified time period. These repayment plans allow consumers to repay their overdrafts and fees in installments.

To assist insured depository institutions in the responsible disclosure and administration of overdraft-protection services, particularly those that are marketed to consumers (a depository institution's customers), the federal banking and thrift agencies issued Joint Guidance on Overdraft Protection Programs. The interagency guidance, issued on February 18, 2005, addresses the agencies' concerns about the potentially misleading implementation, marketing, disclosure, and operation of these programs. (See the "Best Practices" section of the guidance.) The guidance also discusses the agencies' safety-and-soundness considerations and the legal risks of such programs. Institutions are encouraged to carefully review their programs to ensure that their marketing and other communications concerning the programs (1) do not mislead consumers into believing that their programs are traditional lines of credit (when they are not) or that payment of overdrafts is guaranteed, (2) do not mislead consumers about their account balance or the costs and scope of the overdraft protection offered, and (3) do not encourage irresponsible consumer financial behavior that may potentially increase the institution's risk. See SR-05-3 and the attached interagency guidance for detailed discussions of the agencies' concerns and best practices (for marketing and communication with consumers and program features and operation). See also section 3000.1.

Safety-and-Soundness Considerations

When overdrafts are paid, credit is extended to an institution's customers. To the extent overdraft-protection programs lack individual account underwriting, these programs may expose an institution to more credit risk (higher delinquencies and losses) than overdraft lines of credit and other traditional overdraft-protection options.

Institutions providing overdraft-protection programs should adopt written policies and procedures adequate to address the credit, operational, and other risks associated with these types of programs. Prudent risk-management practices include the establishment of express account-eligibility standards and well-defined and properly documented dollar-limit decision criteria. Institutions should also monitor these accounts on an ongoing basis and be able to identify consumers who may represent an undue credit risk to the institution. Overdraft-protection programs should be administered and adjusted, as needed, to ensure that credit risk remains in line with expectations. Program adjustments may include, as appropriate, disqualification of a consumer from future overdraft protection. Management should regularly receive reports sufficient to enable it to identify, measure, and manage overdraft volume, profitability, and credit performance.

Institutions are also expected to incorporate prudent risk-management practices related to account repayment and suspension of overdraft-protection services. These practices include the establishment of specific time frames for when consumers must pay off their overdraft balances. For example, procedures should be established for the suspension of overdraft services when an account holder no longer meets the eligibility criteria (such as when the account holder has declared bankruptcy or defaulted on another loan at the bank) as well as for when an account holder does not repay an overdraft. In addition, overdraft balances should generally be charged off when considered uncollectible, but no later than 60 days from the date first overdrawn. In some cases, an institution may allow a consumer to cover an overdraft through an extended repayment plan when the consumer is unable to bring the account to a positive balance within the required time frames. The existence of the repayment plan, however, would not extend the charge-off determination period beyond 60 days (or a shorter period if applicable), as measured from the date of the overdraft. Any payments received after the account is charged off (up to the amount charged off against the allowance for loan and lease losses) should be reported as a recovery.

Some overdrafts are rewritten as loan obligations in accordance with an institution's loan policy and are supported by a documented assessment of that consumer's ability to repay. In those instances, the institution should use the charge-off time frames described in the Federal Financial Institutions Examination Council's Uniform Retail Credit Classification and Account Management Policy (revised June 6, 2000; effective December 31, 2000). (See SR-00-8.)

Institutions should follow generally accepted accounting principles and the instructions for the Reports of Condition and Income (Call Reports) to report income and loss recognition on overdraft-protection programs. Overdraft balances should be reported on the Report of Condition of the bank Call Report as loans. Accordingly, overdraft losses should be charged off against the allowance for loan and lease losses. All institutions are expected to adopt rigorous loss-estimation processes to ensure that overdraft-fee income is accurately measured. Such methods may include providing loss allowances for uncollectible fees or, alternatively, only recognizing that portion of earned fees estimated to be collectible.[1] The procedures for estimating an adequate allowance should be documented in accordance with the July 2, 2001, interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions.[2] (See SR-01-17.)

If an institution advises account holders of the available amount of overdraft protection, for example, when accounts are opened or on depositors' account statements or automated teller machine (ATM) receipts, the institution should report the available amount of overdraft protection with its other legally binding commitments, for Call Report purposes. These available amounts, therefore, should be reported as "unused commitments."

Risk-Based Capital Treatment of Overdraft Balances

Banks are expected to provide proper risk-based capital treatment of outstanding overdrawn balances and unused commitments. Overdraft balances should be risk-weighted according to the obligor. Under the risk-based capital guidelines, the capital charge on the unused portion of commitments is generally based on an off-balance-sheet credit-conversion factor and the risk weight appropriate to the obligor. (See section 3020.1.) In general, the capital guidelines provide that the unused portion of a commitment is subject to a zero percent credit-conversion factor if the commitment has an original maturity of one year or less, or to a 50 percent credit-conversion factor if the commitment has an original maturity over one year. Under the guidelines, a zero percent conversion factor also applies to the unused portion of a "retail credit card line" or "related plan" if it is unconditionally cancelable by the institution in accordance with applicable law. (See 12 CFR 208, appendix A, section III.D.5.) The phrase "related plans" in the guidelines includes overdraft checking plans. The overdraft-protection programs discussed in the agencies' February 18, 2005, guidance fall within the meaning of "related plans" as a type of "overdraft checking plan" for the purposes of the federal banking agencies' risk-based capital guidelines. Consequently, overdraft-protection programs that are unconditionally cancelable by the institution in accordance with applicable law would qualify for a zero percent credit-conversion factor.

Institutions entering into overdraft-protection contracts with third-party vendors must conduct thorough due-diligence reviews before signing a contract. The November 30, 2000, interagency guidance Risk Management of Outsourced Technology Services outlines the agencies' expectations for prudent practices in this area. (See section 4060.1 and SR-00-17.)

1. Uncollected overdraft fees may be charged off against the allowance for loan and lease losses if such fees are recorded with overdraft balances as loans and if estimated credit losses on the fees are provided for in the allowance for loan and lease losses.

2. The interagency policy statement was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision.

Legal Risks

Overdraft-protection programs must comply with all applicable federal laws and regulations, including the Federal Trade Commission Act (as outlined below). State laws may also be applicable, including usury and criminal laws, as well as laws on unfair or deceptive acts or practices. Before implementing an overdraft-protection program, institutions should have their program reviewed by counsel for compliance with all applicable laws. Further, although the agencies' guidance outlines the applicable federal laws and regulations as of February 2005, such laws and regulations are subject to amendment. Accordingly, institutions should monitor applicable laws and regulations for revisions and ensure that their overdraft-protection programs are fully compliant.

Federal Trade Commission Act. Section 5 of the Federal Trade Commission Act (the FTC Act) prohibits unfair or deceptive acts or practices (15 USC 45). The banking agencies enforce this section pursuant to their authority in section 8 of the Federal Deposit Insurance Act (12 USC 1818).[3] An act or practice is unfair if it causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. An act or practice is deceptive if, in general, it is a representation, omission, or practice that is likely to mislead a consumer acting reasonably under the circumstances and if the representation, omission, or practice is material.

Overdraft-protection programs may raise issues under the FTC Act, depending on how the programs are marketed and implemented. Institutions should closely review all aspects of their overdraft-protection programs, especially any materials that inform consumers about the programs, to avoid engaging in deceptive, inaccurate, misrepresentative, or unfair practices.

3. See the March 2002 OCC Advisory Letter 2002-3 and the March 11, 2004, joint Federal Reserve Board and FDIC interagency guidance Unfair or Deceptive Acts or Practices by State-Chartered Banks.

Examiner's Review of Delinquencies Involving Check-Credit (Overdraft-Protection) Plans

Delinquencies are often experienced when an account is at or near the customer's maximum credit line. Examiners should verify that the following reports are generated for and reviewed by bank management, and examiners should also analyze them as part of the examination process:

- aging of delinquent accounts
- accounts on which payments are made (either on this account or other loans) by drawing on reserves
- accounts with steady usage

Many banks offer check-credit plans to small businesses; these plans may have a higher-than-normal degree of risk unless they are offered under very stringent controls. In these situations, the examiner's review should be based on the same factors and criteria used for the review of unsecured commercial loans.

Credit Card Plans

Most bank credit card plans are similar. The bank solicits retail merchants, service organizations, and others who agree to accept a credit card in lieu of cash for sales or services performed. The bank assumes the credit risk and charges the nonrecourse sales draft to the individual customer's credit card account. The bank sends monthly statements to the customer, who may elect to pay the entire amount or to pay in monthly installments, with an additional percentage charge on the outstanding balance each month. A cardholder may also obtain cash advances, which accrue interest from the transaction date, from the bank or automated teller machines.

A bank can be involved in a credit card plan in various ways. Also, the terminology used to describe the manner in which a bank is involved in a credit card plan may vary. The examiner first needs to determine the type of credit card plan that the bank has and then ascertain the degree of risk that the plan poses to the bank.

Both the bank's customers and the bank itself can generate potential risk in the credit card department. On the customer side, the risk is generally divided into two categories: the misuse of credit and the misuse of the credit card. The potential for credit misuse is reduced by careful screening of cardholders before cards are issued and by monitoring individual accounts for abuse. Credit card misuse may be reduced by establishing controls to prevent the following abuses:

- employees or others from intercepting the card before delivery to the cardholder
- merchants from obtaining control of cards
- fraudulent use of lost or stolen cards

Because credit cards may be easily misused by the cardholders and others who may obtain the cards, strict adherence to appropriate internal controls and operating procedures is essential in any credit card department. The examiner should determine if adequate controls and procedures exist.

Account Management, Risk Management, and the Allowance for Loan and Lease Losses

Credit card lending programs can generate risk through inappropriate account-management, risk-management, and loss-allowance practices. Banks should have and follow prudent policies for credit-line management, over-limit practices, minimum payments, negative amortization, workout and forbearance practices, and recovery practices. In addition, banks should follow generally accepted accounting principles (GAAP), existing interagency policies, and Call Report instructions for income-recognition and loss-allowance practices. In arriving at an overall assessment of the adequacy of a bank's account-management practices for its credit card lending business, examiners should incorporate the risk profile of the bank, the quality of management reporting, and the adequacy of the bank's charge-off policies and its allowance for loan and lease losses methodologies and documentation practices. (See SR-03-01 and the FFIEC January 8, 2003, interagency guidance on credit card lending.)

Credit-line management. Banks should carefully consider the repayment capacity of borrowers when assigning initial credit lines or significantly increasing borrowers' existing credit lines. When a bank inadequately analyzes the repayment capacity of a borrower, practices such as liberal line-increase programs and multiple card strategies can increase the risk profile of a borrower quickly and result in rapid and significant portfolio deterioration.

Credit-line assignments should be managed conservatively using proven credit criteria. Support for credit-line management should include documentation and analysis of decision factors such as a borrower's repayment history, risk scores, behavior scores, or other relevant criteria.

Banks can significantly increase their credit exposure by offering customers additional cards, including store-specific private-label cards and affinity-relationship cards, without considering their entire relationship with a customer. In extreme cases, some banks may grant additional cards to borrowers who are already experiencing payment problems on their existing cards. Banks that offer multiple credit lines should have sufficient internal controls and management information systems (MIS) to aggregate related exposures and analyze performance before they offer additional credit lines to customers.

Over-limit practices. Account-management practices that do not adequately control authorization and provide for timely repayment of over-limit amounts may significantly increase the credit-risk profile of a bank's portfolio. While prudent over-limit practices are important for all credit card accounts, such practices are especially important for subprime accounts. Liberal over-limit tolerances and inadequate repayment requirements in subprime accounts can magnify the high risk exposure of the lending bank, and deficient reporting and loss-allowance methodologies can understate the credit risk.

All banks should carefully manage their over-limit practices and focus on reasonable control and timely repayment of amounts that exceed established credit limits. A bank's MIS should be sufficient to enable its management to identify, measure, manage, and control the unique risks associated with over-limit accounts. Over-limit authorization on open-end accounts, particularly those that are subprime, should be restricted and subject to appropriate policies and controls. The bank's objective should be to ensure that the borrower remains within prudent established credit limits that increase the likelihood of responsible credit management.

Minimum payment and negative amortization. Competitive pressures and a desire to preserve outstanding balances can lead to a bank's easing of minimum-payment requirements, which in turn can increase credit risk and mask portfolio quality. These problems are exacerbated when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and when the outstanding balance continues to build (known as "negative amortization"). In these cases, the lending bank is recording uncollected income by capitalizing the unpaid finance charges and fees into the account balance the customer owes. The pitfalls of negative amortization are magnified when subprime accounts are involved—and are even more damaging when the condition is prolonged by programmatic, recurring overlimit fees and other charges that are primarily intended to increase recorded income for the lending bank rather than enhance the borrowers' performance or their access to credit.

The Federal Reserve expects lending banks to require minimum payments that will amortize the current balance over a reasonable period of time, consistent with the unsecured, consumer-oriented nature of the underlying debt and the borrower's documented creditworthiness. Examiners should criticize prolonged practices involving negative amortization and inappropriate fees, as well as other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality, all of which raise safety-and-soundness concerns.

Workout and forbearance practices. Banks should properly manage workout programs.[4] Areas of concern involve liberal repayment terms with extended amortizations, high charge-off rates, moving accounts from one workout program to another, multiple re-agings, and poor MIS to monitor program performance. Examiners should criticize management and require appropriate corrective action when workout programs are not managed properly. Such actions may include adversely classifying entire segments of portfolios, placing loans on nonaccrual, increasing loss allowances to adequate levels, and accelerating charge-offs to appropriate time frames.

Workout programs should be designed to maximize principal reduction and should generally strive to have borrowers repay credit card debt within 60 months. Repayment terms for workout programs should be consistent with these time frames; exceptions should be clearly documented and supported by compelling evidence that less conservative terms and conditions are warranted. To meet the appropriate time frames, banks may need to substantially reduce or eliminate interest rates and fees on credit card debt so that more of the payment is applied to reducing the principal.

In lieu of workout programs, banks sometimes negotiate settlement agreements with borrowers who are unable to service their unsecured open-end credit. In a settlement arrangement, the bank forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over several months.

Income-recognition and ALLL methodologies and practices. Most banks use historical net charge-off rates, which are based on a migration analysis of the roll rates[5] to charge-off, as the starting point for determining appropriate loss allowances. Banks then typically adjust the historical charge-offs to reflect current trends and conditions and other factors.

Banks should evaluate the collectibility of accrued interest and fees on credit card accounts because a portion of accrued interest and fees is generally not collectible.[6] Although regulatory reporting instructions do not require consumer credit card loans to be placed on nonaccrual on the basis of their delinquency status, all banks should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for

4. A workout is a former open-end credit card account in which credit availability has been closed and the balance owed has been placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization or liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with the original terms but shows the willingness and ability to repay the loan in accordance with modified terms and conditions.

Workout programs generally do not include temporary-hardship programs that help borrowers overcome temporary financial difficulties. However, temporary-hardship programs longer than 12 months, including renewals, should be considered workout programs.

5. *Roll rate* is the percentage of balances or accounts that move from one delinquency stage to the next delinquency stage.

6. AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others,* provides guidance on accounting for delinquency fees.

uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. Banks must account for the owned portion of accrued interest and fees, including related estimated losses, separately from the retained interest in accrued interest and fees from credit card receivables that have been securitized.

A bank's allowance for loan and lease losses should be adequate to absorb credit losses that are probable and estimable on all loans. While some banks provide for an ALLL on all loans, others may only provide for an ALLL on loans that are delinquent. This last practice may result in an inadequate ALLL. Banks should ensure that their loan-impairment analysis and ALLL methodology, including the analysis of roll rates, consider the losses inherent in both delinquent and nondelinquent loans.

A bank's allowance methodologies should always fully recognize the losses inherent in over-limit portfolio segments. For example, if a bank requires borrowers to pay monthly over-limit and other fees in addition to the minimum monthly payment amount, roll rates and estimated losses may be higher than indicated in the overall portfolio migration analysis. Accordingly, banks should ensure that their allowance methodology addresses the incremental losses that may be inherent in over-limit accounts.

A bank's allowances should appropriately provide for the inherent probable loss in workout programs, particularly when a program has liberal repayment periods with little progress in reducing principal. Accounts in workout programs should be segregated for performance-measurement, impairment-analysis, and monitoring purposes. When multiple workout programs with different performance characteristics exist, a bank should track each program separately and establish and maintain adequate allowances for each program. Generally, the allowance allocation should equal the estimated loss in each program based on historical experience as adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, the volume and mix of loans in each program, the terms and conditions of each program, and loan collection activities.

Banks should ensure that they establish and maintain adequate loss allowances for credit card accounts that are subject to settlement arrangements. In addition, the FFIEC Uniform Retail Credit Classification and Account Management Policy states that "actual credit losses on individual retail loans should be recorded when the bank becomes aware of the loss." In general, the amount of debt forgiven in a settlement arrangement should be classified as loss and charged off immediately. Immediate charge-off, in some circumstances, however, may be impractical. In such cases, banks may treat amounts forgiven in settlement arrangements as specific allowances.[7] Upon receipt of the final settlement payment, banks should charge off deficiency balances within 30 days.

Recovery practices. After a credit card loan is charged off, banks must properly report any subsequent collections on the loan.[8] Typically, banks report some or all of such collections on charged-off credit card loans as recoveries to the ALLL. If the total amount a bank credits to the ALLL as the recovery on an individual credit card loan (which may include principal, interest, and fees) exceeds the amount previously charged off against the ALLL on that loan (which may have been limited to principal), then the bank's net charge-off experience—an important indicator of the credit quality and performance of its portfolio—will be understated. Banks must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

Re-aging of credit card receivables. The examiner should review the bank's credit card receivables to determine if re-aging occurs. Re-aging refers to the removal of a delinquent account from normal collection activity after the borrower has demonstrated over time that he or she is capable of fulfilling contractual obligations without the intervention of the bank's collection department. The bank may use re-aging when a customer makes regular and consecutive payments over a period of time that maintain the account at a consistent delinquency level or reduce the delinquency level with minimal collection effort. Re-aging, in effect, changes the delinquency-payment status of a credit card

7. For regulatory reporting purposes, banks should report the creation of a specific allowance as a charge-off in Schedule RI-B of the call report.

8. AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

receivable from a past-due to a current status. The examiner should determine if the bank re-ages its accounts on an exception basis or as a regular practice. The bank should document those accounts that have been re-aged, obtain appropriate approval, and ensure that re-aging is done in conformance with internal policies and procedures. (See “Bank Classification and Charge-Off Policy” later in this section and SR-00-8 for further guidance.)

Exceptions to examiner guidance. From time to time, banks with well-managed programs may authorize, and provide a basis for granting, limited exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy. The basis for granting exceptions to the policy should be identified and described in the bank’s policies and procedures. Such policies and procedures should address the types of exceptions allowed and the circumstances for permitting them. The volume of accounts granted exceptions should be small and well controlled, and the performance of these accounts should be closely monitored. Examiners will evaluate whether a bank uses its exceptions prudently. Examiners should criticize management and require corrective action when exceptions are not used prudently, are not well managed, result in improper reporting, or mask delinquencies and losses.

LOAN POLICY

A written consumer credit policy provides bank management with the framework to underwrite and administer the risk inherent in lending money while establishing a mechanism for the board of directors or senior management to monitor compliance. The policy should establish the authority, rules, and guidelines to operate and administer the bank’s consumer loan portfolio effectively; that is, the policy should help manage risk while ensuring profitability. The policy should set basic standards and procedures clearly and concisely. The policy’s guidelines should be derived from a careful review of internal and external factors that affect the bank. To avoid any discriminatory policies or practices, the policy should include guidelines on the various consumer credit laws and regulations.

The composition of the loan portfolio will differ considerably among banks because lending activities are influenced by many factors, including the type of institution, management’s objectives and philosophies on diversification and risk, the availability of funds, and credit demand. An effective lending policy and commensurate procedures are integral components of the lending process. The bank’s consumer credit policy should accomplish the following:

- define standards, rules, and guidelines for the credit-evaluation process, with the following specific goals:
  - — establish minimum and maximum loan maturities
  - — establish minimum levels of creditworthiness
  - — create consistency within the bank’s underwriting process
  - — ensure uniformity in how the bank’s consumer credit products are offered to borrowers
- provide a degree of flexibility, which allows credit officers and management to use their knowledge, skills, and experience
- provide specific guidelines for determining the creditworthiness of applicants; these guidelines might include the following:
  - — minimum income levels
  - — maximum debt-to-income ratios
  - — job or income stability
  - — payment history on previous obligations
  - — the type and value of collateral
  - — maximum loan-to-value ratios on various types of collateral
  - — a minimum score on a credit scoring system
- provide guidelines for the level and type of documentation to be maintained, including—
  - — a signed application
  - — the identity of the borrower and his or her occupation
  - — documentation of the borrower’s financial capacity
  - — a credit bureau report
  - — the purpose of all loans granted to the borrower, the sources of repayment, and the repayment programs
  - — documentation of the collateral, its value, and the source of the valuation
  - — documents perfecting the lien on the collateral
  - — verification worksheets and supporting documentation

— a credit scoring worksheet, if applicable
— the sales contract and related security agreements, if applicable
— evidence of insurance coverage, if applicable
— any other documentation received or prepared in conjunction with the credit request

• define procedures for handling delinquent consumer credit loans and the subsequent charge-off and possible re-aging of those loans

The consumer credit policy should also provide guidelines for granting loans that do not conform to the bank's written lending policy or procedures. The policy should require that the reason for the exception be detailed in writing, submitted for approval to a designated authority, and documented in the loan file. Credit exceptions should be reviewed by the appropriate bank committee. The frequency of exceptions granted may indicate a lessening of underwriting standards or a need to adjust the policy to allow flexibility within safe and sound parameters. The examiner should assess the exceptions and make recommendations accordingly.

Obtaining and maintaining complete and accurate information on every consumer credit applicant is essential to approving credit in a safe and sound manner. The loan policy should establish what information will be required from the borrower during the application process and what, if any, subsequent information the borrower will be required to submit while the credit remains outstanding. Credit files should be maintained on all borrowers, regardless of the credit amount, with the exception of the latitude provided by the March 30, 1993, Interagency Policy Statement on Documentation of Loans. Each borrower's credit file should include the names of all other borrowers who are part of the same borrowing relationship, or the bank should have some other system for informing the reader of a credit file that the borrower is part of a more extensive credit relationship. A current credit file should provide the loan officer, loan committee, and internal and external reviewers with all information necessary to (1) analyze the credit before it is granted and (2) monitor the credit during its life.

Documentation requirements will vary according to the type of loan, borrower, and collateral. For example, the bank may not require a financial statement from a borrower whose loans are fully secured by certificates of deposit issued by the bank. For most consumer credit loans, the borrower's financial information is collected only at the time of the loan application.

OPERATIONAL RISK

The management of the consumer credit function and the accompanying internal controls is of primary importance to the safe, sound, and profitable operation of a bank. In evaluating controls for consumer credit administration, the examiner should review (1) the bank's adherence to policies and procedures and (2) the operational controls over recordkeeping, payments, and collateral records to ensure that risks are controlled properly. (See "Loan Portfolio Management," section 2040.1, for an overview of the various types of risk that the bank should be aware of and the controls it should implement to effectively manage risk.) Risks that are inherent to the consumer credit function and that require internal controls include, but are not limited to, the following:

• *Insurance.* All insurance policies on file should name the bank as loss payee. The bank should maintain a tickler system to monitor the expiration of insurance policies. In addition, the bank should implement procedures to ensure single-interest insurance coverage is obtained in case the borrower's insurance is canceled or expires.

• *Security agreements.* The bank should implement procedures to ensure that lien searches are performed and that liens are perfected by appropriate filings.

• *Indirect installment loans.* The bank should implement procedures to reduce the risk that can occur in this area. These procedures should ensure the following:
  — payments are made directly to the bank and not through the dealer
  — dealer lines are reaffirmed at least annually
  — selling prices as listed by the dealer are accurate
  — credit checks on the borrowers are performed independently of the dealer
  — overdrafts are prohibited in the dealer reserve and holdback accounts
  — past-due accounts are monitored in aggregate per dealer to assess the quality of loans received from each individual dealer

CREDIT SCORING SYSTEM

Credit scoring is a method for predicting how much repayment risk consumer credit borrowers present. Credit scoring systems are developed using application or credit bureau data on consumers whose performance has already been categorized as creditworthy or noncreditworthy. Items of information that help predict acceptable performance are identified and assigned point values relative to their overall importance. These values are then totaled to calculate an overall credit score.

The credit score is used to approve credit, and frequently allows a bank to avoid the costly and time-consuming process of individual underwriting. Management determines a minimum score, which is sometimes called the cutoff score. Borrowers whose credit scores are not within the approved cutoff-score range for the type of loan requested do not meet the bank's minimum underwriting criteria. However, the bank may override a borrower's unacceptable credit score when other mitigating factors are present that may not have been included in the credit score. Exceptions to the bank's credit scoring system should be documented.

A number of banks have developed and implemented credit scoring systems as part of the approval process for consumer credit; other banks use traditional methods that rely on a credit officer's subjective evaluation of an applicant's creditworthiness. Credit scoring systems are replacing credit officers' subjective evaluation of borrowers' creditworthiness in more and more banks, particularly in larger institutions. Credit scoring systems are divided into two categories: (1) empirically derived, demonstrably and statistically sound credit systems and (2) judgmental systems.

Empirically derived credit scoring systems are generally defined as systems that evaluate creditworthiness by assigning points to various attributes of the applicant and, perhaps, to attributes of the credit requested. The points assigned are derived from a statistical analysis of recent creditworthy and noncreditworthy applicants of the bank. An empirically derived credit scoring system is statistically sound when it meets the following requirements:

- The data used to develop the system are derived from an empirical comparison of sample groups or from the population of creditworthy and noncreditworthy applicants who applied for credit within a reasonably recent period of time.
- The system is developed to evaluate the creditworthiness of applicants in order to serve the legitimate business interests of the bank using the system.
- The system is developed and validated using statistical principles and methodology.
- The bank periodically reevaluates the predictive ability of the system by using statistical principles and methodologies and adjusts the system as necessary.

An empirically derived credit scoring system may take the age of an applicant into account as a predictive variable, provided that the age of an elderly applicant is not assigned a negative factor or value. In a judgmental system, which relies on a credit officer's personal evaluation of a potential borrower's creditworthiness, a creditor may not take age directly into account. However, the applicant's age may be related to other information that the creditor considers in evaluating creditworthiness. For example, a creditor may consider the applicant's occupation and length of time to retirement to ascertain whether the applicant's income (including retirement income) will support the extension of credit to maturity. Consumer credit regulations allow any system of evaluating creditworthiness to favor an applicant who is 62 or older.

If the bank has a credit scoring system, the examiner should review the items or customer attributes that are included in it. In general, credit scoring systems are built on an experiential or historical database. Credit scoring methods analyze the experiences of individuals who have been previously granted credit and divide them into creditworthy and noncreditworthy accounts for purposes of predicting future extensions of consumer credit.

A successful credit scoring system provides a standardized way of measuring the inherent risk of the borrower. An important measure of any credit scoring system is its definition of risk and the care with which explanatory variables are defined, data are collected, and the system is tested. The standardized risk measurement should be fundamentally sound, be based on historical data, measure the risk of default (or loss), and produce consistent results across time for a wide range of borrowers. The bank should further investigate potential borrowers who do not meet the credit scoring criteria.

Some banks may use more than one type of credit scoring methodology in their underwriting and account-management practices. The following are three examples of credit scoring systems:

- *Credit bureau scoring.* The bank uses a consumer's credit bureau information in a scoring formula. The scoring model is developed by the various credit bureaus, using the reported experience of all credit grantors with whom the applicant has or has had a relationship.
- *Custom-application scoring.* The bank uses both a consumer's application and credit bureau data in a scoring formula. This scoring model is developed using only information on the bank's applicants and borrowers.
- *Behavioral scoring.* The bank uses a formula that includes a borrower's repayment history, account utilization, and length of time with the bank to calculate a risk score for revolving accounts.

Applicants who fail the scoring process may still be judgmentally reviewed if additional information exists that may not have been included in the scoring formula. In addition, if an applicant passes the scoring process, but other information indicates that the loan should not be made, the applicant can be denied but the reason for the credit denial should be documented.

BANK CLASSIFICATION AND CHARGE-OFF POLICY

Consumer credit loans, based on their volume and size, are generally classified using criteria that are different from the classification of other types of loans. The examiner should use the Uniform Retail Credit Classification and Account Management Policy[9] when determining consumer credit classifications. (See the appendix to this section.)

A bank should have procedures detailing when consumer credit loans become watch list or problem credits. In addition, the bank should have charge-off procedures for consumer credit loans. The examiner should review the bank's policies and procedures for adequacy and compliance.

Identification of unfavorable trends must include the review of past-due percentages and income and loss trends in the consumer credit department, which management should monitor closely. Unfortunately, in banks that lack a well-enforced charge-off program, loss ratios are often meaningless for periods of less than a year. As a result, bank management may not become aware of downward trends until year-end or examiner-initiated charge-offs are made. Recognition and implementation of any necessary corrective action are thus delayed.

The examiner should determine whether the bank has adopted a well-enforced charge-off procedure. If so, his or her review should be limited to ascertaining that exceptions meet established guidelines. If the bank is properly charging off delinquent consumer credit loans in the normal course of business under a policy that generally conforms to that of the Federal Reserve System, no specific request for charge-off should be necessary. When the bank has not established a program to ensure the timely charge-off of delinquent accounts, such a program should be recommended in the examination report. If material misstatements in the FFIEC Consolidated Reports of Condition and Income (Call Reports) for previous quarters have resulted from management's failure to charge off loans, management should be instructed to amend the Call Reports for each affected quarter. The following loans are subject to the uniform classification policy:

- All loans to individuals for household, family, and other personal expenditures as defined in the Call Reports.
- Mobile home paper, except when applicable state laws define the purchase of a mobile home as the purchase of real property and the loan is secured by the purchased mobile home as evidenced by a mortgage or similar document.
- Federal Housing Authority (FHA) title 1 loans. These loans are also subject to the following classification criteria:

9. The 1980 Federal Financial Institutions Examination Council (FFIEC) policy was revised and issued in February 1999 and June 2000. The June 2000 policy replaces the 1980 policy and its February 1999 revision. Reporting on the FFIEC Call Report, based on the revised policy, is not required until December 31, 2000. In addition to discussing the revised policy statement, SR-00-8 advises examiners to consider the methodology used for aging retail loans. In accordance with the FFIEC Call Report instructions, banks and their consumer finance subsidiaries are required to use the contractual method, which ages loans based on the status of contractual payments.

- — Uninsured portions should be charged off when claims have been filed.
- — When claims have not been filed, uninsured delinquent portions should be classified in accordance with the delinquent-installment-loan classification policy.
- — The portion covered by valid insurance is not subject to classification.

The uniform classification policy includes consumer credit loans. Small, delinquent consumer credit loans may be listed for classification purposes in the report of examination without detailed comments. Larger classified consumer loans might need to be supported with detailed comments. When no specific procedures have been established, or when adherence to the established procedures is not evident, the examiner should make every effort to encourage the bank to adopt and follow acceptable procedures.

REPOSSESSED PROPERTY

Repossessed property should be booked at its fair value, less cost to sell, on the date the bank obtains clear title and possession of the property. Any outstanding loan balance in excess of the fair value of the property, less selling costs, should be charged off. Periodic repricing should be performed, and appropriate accounting entries should be made when necessary. Generally, repossessed property should be disposed of within 90 days of obtaining possession, unless legal requirements stipulate a longer period.

VIOLATIONS OF LAW

The consumer credit department is particularly susceptible to violations of the various consumer credit laws and regulations. These types of violations may result in serious financial penalties and loss of public esteem. Therefore, the examiner must be aware of any violations discovered during the consumer compliance examination and ensure that corrective action has been effected. All examiners should be familiar with the various consumer credit laws and regulations and be alert to potential violations.

APPENDIX—RETAIL-CREDIT CLASSIFICATION POLICY

The revised June 2000 Uniform Retail Credit Classification and Account Management Policy issued by the FFIEC and approved by the Federal Reserve Board is reproduced below. The Board has clarified certain provisions of this policy. In this text, the Board's revisions are in brackets.

The Uniform Retail Credit Classification and Account Management Policy[10] establishes standards for the classification and treatment of retail credit by financial institutions. Retail credit consists of open- and closed-end credit extended to individuals for household, family, and other personal expenditures, and includes consumer loans and credit cards. For purposes of this policy, retail credit also includes loans to individuals secured by their personal residence, including first mortgage, home equity, and home-improvement loans. Because a retail-credit portfolio generally consists of a large number of relatively small-balance loans, evaluating the quality of the retail-credit portfolio on a loan-by-loan basis is inefficient and burdensome for the institution being examined and for examiners.

Actual credit losses on individual retail credits should be recorded when the institution becomes aware of the loss, but in no case should the charge-off exceed the time frames stated in this policy. This policy does not preclude an institution from adopting a more conservative internal policy. Based on collection experience, when a portfolio's history reflects high losses and low recoveries, more conservative standards are appropriate and necessary.

The quality of retail credit is best indicated by the repayment performance of individual borrowers. Therefore, in general, retail credit should be classified based on the following criteria:

- Open- and closed-end retail loans past due 90 cumulative days from the contractual due date should be classified substandard.
- Closed-end retail loans that become past due 120 cumulative days and open-end retail loans that become past due 180 cumulative days from the contractual due date should be classified loss and charged off.[11] In lieu of charg-

10. [For the Federal Reserve's classification guidelines, see section 2060.1, "Classification of Credits."]

11. For operational purposes, whenever a charge-off is

ing off the entire loan balance, loans with non–real estate collateral may be written down to the value of the collateral, less cost to sell, if repossession of collateral is assured and in process.

- One- to four-family residential real estate loans and home equity loans that are past due 90 days or more with loan-to-value ratios greater than 60 percent should be classified substandard. Properly secured residential real estate loans with loan-to-value ratios equal to or less than 60 percent are generally not classified based solely on delinquency status. Home equity loans to the same borrower at the same institution as the senior mortgage loan with a combined loan-to-value ratio equal to or less than 60 percent need not be classified. However, home equity loans where the institution does not hold the senior mortgage, that are past due 90 days or more should be classified substandard, even if the loan-to-value ratio is equal to, or less than, 60 percent.
- For open- and closed-end loans secured by residential real estate, a current assessment of value should be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less cost to sell, should be classified loss and charged off.
- Loans in bankruptcy should be classified loss and charged off within 60 days of receipt of notification of filing from the bankruptcy court or within the time frames specified in this classification policy, whichever is shorter, unless the institution can clearly demonstrate and document that repayment is likely to occur. Loans with collateral may be written down to the value of the collateral, less cost to sell. Any loan balance not charged off should be classified substandard until the borrower re-establishes the ability and willingness to repay for a period of at least six months.
- Fraudulent loans should be classified loss and charged off no later than 90 days of discovery or within the time frames adopted in this classification policy, whichever is shorter.
- Loans of deceased persons should be classified loss and charged off when the loss is determined or within the time frames adopted in this classification policy, whichever is shorter.

Other Considerations for Classification

If an institution can clearly document that a past-due loan is well secured and in the process of collection, such that collection will occur regardless of delinquency status, then the loan need not be classified. A well-secured loan is collateralized by a perfected security interest in, or pledges of, real or personal property, including securities with an estimable value, less cost to sell, sufficient to recover the recorded investment in the loan, as well as a reasonable return on that amount. "In the process of collection" means that either a collection effort or legal action is proceeding and is reasonably expected to result in recovery of the loan balance or its restoration to a current status, generally within the next 90 days.

Partial Payments on Open- and Closed-End Credit

Institutions should use one of two methods to recognize partial payments. A payment equivalent to 90 percent or more of the contractual payment may be considered a full payment in computing past-due status. Alternatively, the institution may aggregate payments and give credit for any partial payment received. For example, if a regular installment payment is $300 and the borrower makes payments of only $150 per month for a six-month period, [the institution could aggregate the payments received ($150 × six payments, or $900). It could then give credit for three full months ($300 × three payments) and thus treat the loan as] three full months past due. An institution may use either or both methods in its portfolio, but may not use both methods simultaneously with a single loan.

necessary under this policy, it should be taken no later than the end of the month in which the applicable time period elapses. Any full payment received after the 120- or 180-day charge-off threshold, but before month-end charge-off, may be considered in determining whether the charge-off remains appropriate.

OTS regulation 12 CFR 560.160(b) allows savings institutions to establish adequate (specific) valuation allowances for assets classified loss in lieu of charge- offs.

Open-end retail accounts that are placed on a fixed repayment schedule should follow the charge-off time frame for closed-end loans.

Re-aging, Extensions, Deferrals, Renewals, and Rewrites

Re-aging of open-end accounts, and extensions, deferrals, renewals, and rewrites of closed-end loans[12] can be used to help borrowers overcome temporary financial difficulties, such as loss of job, medical emergency, or change in family circumstances like loss of a family member. A permissive policy on re-agings, extensions, deferrals, renewals, or rewrites can cloud the true performance and delinquency status of the portfolio. However, prudent use is acceptable when it is based on a renewed willingness and ability to repay the loan, and when it is structured and controlled in accordance with sound internal policies.

Management should ensure that comprehensive and effective risk management and internal controls are established and maintained so that re-ages, extensions, deferrals, renewals, and rewrites can be adequately controlled and monitored by management and verified by examiners. The decision to re-age, extend, defer, renew, or rewrite a loan, like any other modification of contractual terms, should be supported in the institution's management information systems. Adequate management information systems usually identify and document any loan that is re-aged, extended, deferred, renewed, or rewritten, including the number of times such action has been taken. Documentation normally shows that the institution's personnel communicated with the borrower, the borrower agreed to pay the loan in full, and the borrower has the ability to repay the loan. To be effective, management information systems should also monitor and track the volume and performance of loans that have been re-aged, extended, deferred, renewed, or rewritten and/or placed in a workout program.

12. These terms are defined as follows. *Re-age*: Returning a delinquent, open-end account to current status without collecting [at the time of aging] the total amount of principal, interest, and fees that are contractually due. *Extension*: Extending monthly payments on a closed-end loan and rolling back the maturity by the number of months extended. The account is shown current upon granting the extension. If extension fees are assessed, they should be collected at the time of the extension and not added to the balance of the loan. *Deferral*: Deferring a contractually due payment on a closed-end loan without affecting the other terms, including maturity [or the due date for subsequently scheduled payments] of the loan. The account is shown current upon granting the deferral. *Renewal*: Underwriting a matured, closed-end loan generally at its outstanding principal amount and on similar terms. *Rewrite*: Underwriting an existing loan by significantly changing its terms, including payment amounts, interest rates, amortization schedules, or its final maturity.

Open-End Accounts

Institutions that re-age open-end accounts should establish a reasonable written policy and adhere to it. To be considered for re-aging, an account should exhibit the following:

- The borrower has demonstrated a renewed willingness and ability to repay the loan.
- The account has existed for at least nine months.
- The borrower has made at least three consecutive minimum monthly payments or the equivalent cumulative amount. Funds may not be advanced by the institution for this purpose.

Open-end accounts should not be re-aged more than once within any twelve-month period and no more than twice within any five-year period. Institutions may adopt a more conservative re-aging standard; for example, some institutions allow only one re-aging in the lifetime of an open-end account. Additionally, an over-limit account may be re-aged at its outstanding balance (including the over-limit balance, interest, and fees), provided that no new credit is extended to the borrower until the balance falls below the predelinquency credit limit.

Institutions may re-age an account after it enters a workout program, including internal and third-party debt-counseling services, but only after receipt of at least three consecutive minimum monthly payments or the equivalent cumulative amount, as agreed upon under the workout or debt-management program. Re-aging for workout purposes is limited to once in a five-year period and is in addition to the once-in-twelve-months/twice-in-five-years limitation described above. To be effective, management information systems should track the principal reductions and charge-off history of loans in workout programs by type of program.

Closed-End Loans

Institutions should adopt and adhere to explicit standards that control the use of extensions, deferrals, renewals, and rewrites of closed-end loans. The standards should exhibit the following:

- The borrower should show a renewed willingness and ability to repay the loan.
- The standards should limit the number and frequency of extensions, deferrals, renewals, and rewrites.
- Additional advances to finance unpaid interest and fees should be prohibited.

Management should ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained to support the collection process and to ensure timely recognition of losses. To be effective, management information systems should track the subsequent principal reductions and charge-off history of loans that have been granted an extension, deferral, renewal, or rewrite.

Examination Considerations

Examiners should ensure that institutions adhere to this policy. Nevertheless, there may be instances that warrant exceptions to the general classification policy. Loans need not be classified if the institution can document clearly that repayment will occur irrespective of delinquency status. Examples might include loans well secured by marketable collateral and in the process of collection, loans for which claims are filed against solvent estates, and loans supported by valid insurance claims.

The Uniform Retail Credit Classification and Account Management Policy does not preclude examiners from classifying individual retail-credit loans that exhibit signs of credit weakness regardless of delinquency status. Similarly, an examiner may also classify retail portfolios, or segments thereof, where underwriting standards are weak and present unreasonable credit risk, and may criticize account-management practices that are deficient.

In addition to reviewing loan classifications, the examiner should ensure that the institution's allowance for loan and lease losses provides adequate coverage for probable losses inherent in the portfolio. Sound risk- and account-management systems, including a prudent retail-credit lending policy, measures to ensure and monitor adherence to stated policy, and detailed operating procedures, should also be implemented. Internal controls should be in place to ensure that the policy is followed. Institutions that lack sound policies or fail to implement or effectively adhere to established policies will be subject to criticism.

Issued by the FFIEC on June 12, 2000.

1. To determine the quality and adequacy of operations (including the adequacy of lending policies, practices, procedures, internal controls, and management information systems) for consumer credit and credit card plans.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the consumer credit portfolio for credit quality, performance, adequate collateral, and collectibility.
4. To determine the scope and adequacy of the audit and loan-review function.
5. To determine the level of risk inherent in a bank's consumer credit and credit card lending departments and what actions management has taken to identify, measure, control, and monitor the level and types of risks.
6. To determine that the goals and objectives of specific credit card plans are being achieved and that the plans are profitable.
7. To determine compliance with the board of directors' and senior management's policies and procedures and with applicable laws and regulations.
8. To initiate corrective action when policies, procedures, practices, or internal controls are deficient or when violations of law or regulations have been noted.

GENERAL CONSUMER CREDIT

1. If selected for implementation, complete or update the installment loan section of the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or 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. Obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors. If applicable, also determine if the latest consumer compliance examination disclosed any violation of laws or regulations. Determine if corrective action has been taken.
4. Request that the bank supply the following:
   a. a listing of all dealers who have indirect-paper, fleet-leasing, or discounted-lease lines, along with respective codes
   b. an indirect paper or a fleet-leasing or discounted fleet-leasing report by code, along with the respective delinquency report for all loans past due 30 days or more
   c. a listing of dealer reserves, holdback accounts, or both showing the dealer, account number, and balance
   d. the latest month-end extension and renewal reports
   e. a schedule of all loans with irregular or balloon payments or both
   f. a schedule of all loans with more than five prepaid installments
   g. a listing of loans generated by brokers or finders
   h. a listing of current repossessions, including the name of the borrower, a description of the item, the date of repossession, the date title was acquired, and the balance
   i. a copy of each monthly installment-loan charge-off report since the preceding examination (If the monthly reports do not include all the information necessary to support the charge-off of the installment loans, request a revised listing that includes the missing information for each charge-off.)
   j. management reports that are prepared by department personnel and that are not forwarded in their entirety to the board of directors or its committee
   k. a listing of the amount of recoveries on charged-off installment loans, by month, since the preceding examination
   l. a listing of all outstanding loans that have been assigned to an attorney for collection
   m. an identification of all columns and codes on the computer printout
5. Obtain a trial balance of installment loans. Use of the bank's latest trial balance is acceptable. If exact figures are required, update the trial balance from the daily transaction journals. Using the trial balance—
   a. agree or reconcile balances to department controls and the general ledger and
   b. review reconciling items for reasonableness.
6. Using an appropriate sampling technique, select borrowers' loans to be reviewed during the examination.
7. Using an appropriate technique, select indirect dealers and fleet-leasing and indirect-lease lines from indirect-dealer or leasing reports. Transcribe the following onto consumer finance indirect line cards:
   a. the amount and number of contracts, indicating whether they are with or without recourse
   b. the amount and number of contracts still accruing that are past due 30–89 days and 90 days or more
   c. the balance in dealer reserve or holdback accounts or both
8. Obtain the following schedules from the bank or the appropriate examiner if they are applicable to this area:
   a. past-due loans (obtain separate schedules by branch, if available)
   b. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   c. loans acquired from another lending institution as a result of a purchase,

participation, or asset swap since the previous examination
- d. loan commitments and other contingent liabilities
- e. extensions of credit to employees, officers, directors, principal shareholders, and their interests, specifying which officers are considered executive officers
- f. correspondent banks' extensions of credit to executive officers, directors, and principal shareholders and their interests
- g. a list of correspondent banks
- h. miscellaneous loan debit-and-credit suspense accounts
- i. loans considered "problem loans" by management
- j. each officer's current lending authority
- k. the current structure of interest rates
- *l.* any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
- m. reports furnished to the loan and discount committee or any similar committee
- n. reports furnished to the board of directors
- o. loans classified during the preceding examination
- p. the extent and nature of loans serviced

9. Review the information received and perform the following for—
   - a. Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap:
     - Participations only:
       - — Test participation certificates and records and determine that the parties share in the risks and contractual payments on a pro rata basis.
       - — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
     - Procedures pertaining to *all* transfers:
       - — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred to avoid possible criticism during the examination.
       - — Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
       - — Determine that low-quality loans transferred to or from the bank are properly reflected on its books at fair value (while fair value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium).
       - — Determine that low-quality loans transferred to the parent holding company or a nonbank affiliate are properly reflected at fair value on the books of both the bank and its affiliate.
       - — If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
         - (1) name of originating institution
         - (2) name of receiving institution
         - (3) type of transfer (i.e., participation, purchase/sale, swap)
         - (4) date of transfer
         - (5) total number of loans transferred
         - (6) total dollar amount of loans transferred
         - (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
         - (8) any other information that would be helpful to the other regulator
   - b. Miscellaneous loan debit-and-credit suspense accounts:
     - Discuss with management any large or old items.
     - Perform additional procedures as considered appropriate.
   - c. For loan commitments and other contingent liabilities, if the borrower has been advised of the commitment and it exceeds the cutoff alone or in combination with any outstanding debt, prepare a line card for subsequent analysis and review.

d. For loans classified during the previous examination, determine the disposition of loans so classified by—
   - obtaining current balances and their payment status, or the date the loan was repaid and source of payment;
   - investigating any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or were a result of a participation, sale, or swap with another lending institution; and
   - referring to step 9a of this section for the appropriate examination procedures, determine if repayment was a result of a participation, sale, or swap.

e. Select loans that require in-depth review on the basis of information derived from the above schedules.

10. Consult with the examiner responsible for the asset-liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See section 6000.1, "Instructions for the Report of Examination," for considerations to be taken into account when compiling maturity information for the gap analysis.
11. Obtain liability and other information on common borrowers from examiners assigned to overdrafts, lease financing, and other loan areas. Together decide who will review the borrowing relationship.
12. Obtain the credit files of all direct nonconsumer borrowers, indirect dealers, and fleet-leasing and discounted-leasing lines for which line cards have been developed. Transcribe and analyze the following as appropriate:
    a. the purpose of the loan
    b. collateral information, including its value and the bank's right to hold and negotiate it
    c. the source of repayment
    d. ancillary information, including the type of business, its officers, and its affiliation
    e. fiscal and interim financial exhibits
    f. guarantors and the amount of any guarantee
    g. personal statements of borrowers, endorsers, or guarantors
    h. external credit checks and credit bureau reports
    i. loan officer's credit memoranda
    j. subordination agreements
    k. a corporate resolution to borrow or guarantee
    l. provisions of the loan agreement or master lease agreement
    m. the type of dealer endorsement:
       - full recourse
       - limited recourse
       - nonrecourse
    n. dealer repurchase agreements
    o. reserve and holdback requirements
    p. the amount of insurance coverage
13. Check the central liability file on borrowers indebted above the cutoff or borrowers displaying credit weakness who are suspected of having additional liability in other loan areas.
14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers for which line cards have been developed. Cross-reference, if appropriate.
15. Review a listing of loans generated by brokers or finders:
    a. Check the quality of the paper being acquired.
    b. Determine that sufficient financial data have been obtained to support the credits.
    c. Evaluate performance.
16. Review the current past-due (delinquent) loan list and determine that loans are aged using the contractual method, which ages a loan on the basis of its contractual repayment terms, as required by the Call Report instructions. Discuss with management selected delinquent loans from the listings of delinquent loans and repossessed collateral.
17. Determine if management has a general policy for the timely classification and charge-off of past-due loans and ascertain whether the policy is adhered to. Determine if loan-classification practices follow the board of directors' respective policies. Ascertain whether those policies comply with the provisions of the FFIEC's Uniform Retail Credit Classification and Account Management Policy and with Federal Reserve policy. Review with management individual accounts that have not been charged off in line with these policies.
18. Review voluntary charge-offs made since the preceding examination and, on a test basis, review files on borrowers and ascertain the correctness of the charge-off.

19. Review any reports being submitted on delinquent and defaulted loans guaranteed by government agencies:
    a. Determine that management is informed accurately and is complying with the reporting requirements.
    b. Determine that claims are being promptly filed after default.

OVERDRAFT-PROTECTION PROGRAMS

1. Determine if the bank has developed and implemented adequate written overdraft-protection-program policies and procedures for its ad hoc, automated, and other overdraft programs. Determine if the policies and procedures comply with the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs.
2. Ascertain whether the bank's management emphasizes and monitors adherence to its overdraft policies and procedures, applies generally accepted accounting principles to overdraft transactions, and applies the bank Call Report's accounting and reporting instructions and requirements to overdrafts. Evaluate whether the bank maintains and monitors safe and sound overdraft business practices to control the credit, operational, and other risks associated with overdraft programs.
3. Apply the additional examination procedures for overdraft-protection programs (see section 3000.3) when weaknesses are found in (1) the bank's compliance with the February 2005 interagency guidance and (2) the bank's evaluation of the risks associated with overdraft-protection programs.

CREDIT CARD LENDING

The examiner's analysis of operating policies and procedures is key to the examination of credit card banks and credit card operations. Credit card lending is characterized by a high volume of accounts, homogeneous loan pools, and small-dollar balances. A concentrated review of individual accounts, therefore, may not be practical. Examination procedures should focus on evaluating policies, procedures, and internal controls in conjunction with performing other selected functions. The goal is not confined to identifying current portfolio problems. The examination process should include an investigation of potential problems that may result from ineffective policies, unfavorable trends, lending concentrations, or nonadherence to policies. The following examination procedures should be performed.

1. Review UBPR data to determine the volume of credit card activity.
2. Determine if management has recently offered or plans to offer new products or if management plans to enter new market niches or expand the credit card portfolio significantly (new offerings may include affinity cards, co-branded cards, secured cards, or purchasing cards).
3. Determine whether the bank is engaged or plans to engage in subprime credit card lending. If subprime lending exists or is planned, perform the subprime-lending examination procedures in section 2133.3.
4. Review correspondence that the bank has received or exchanged with credit card networks (i.e.,Visa, MasterCard). These agencies perform periodic reviews of their members.

Policy Considerations

1. Review the credit card policy. Policy guidelines should include the following items:
    a. adequate screening of account applicants
    b. standards for approving accounts and determining credit-line size
    c. minimum standards for documentation
    d. internal controls to prevent and detect fraud, such as—
        - review procedures, including frequent review of delinquent accounts;
        - delinquency notification and collection procedures;
        - criteria for freezing accounts and charging off balances;
        - criteria for curing and re-aging delinquent accounts;
        - controls to avoid reissuances of expired cards to obligors who have unsatisfactory credit histories;
        - approvals of and controls over over-limits and overrides; and
        - cardholder information security controls

e. due diligence before engaging the service of a third party, as well as the ongoing management of credit card operations

Audit

1. Review the adequacy of the audit function regarding credit card operations.
   a. Determine if the audit program identifies contraventions of internal policy, credit card network (i.e., Visa, MasterCard) regulations, and written contracts.
   b. Determine if audit procedures include reviewing the accuracy and integrity of the bank's system for reporting the past-due status of credit card loans, over-limit accounts, and other management information systems.
   c. Determine if audit procedures include reviewing computer-driven models.
   d. Determine if independent tests of automated procedures are performed (for example, a sample of automatically re-aged accounts may be independently reviewed to test the integrity of automated systems).
   e. Determine whether audit procedures include a review of credit card processing operations. Ascertain if the product control file governing credit card processing was reviewed and whether it revealed any significant internal control weaknesses, such as a lack of segregation of duties and access controls. Determine whether management is aware of the risks and if the audit staff has the expertise to adequately evaluate procedures and suggest controls commensurate with the risks.
   f. Determine if audit procedures include a review of the services provided by outside vendors (services such as telemarketing, data processing, and direct mail). Ascertain if the audit procedures included a review of the performance of the vendors and documentation of the relationships.
2. Determine if management has reviewed and appropriately responded to audit findings regarding credit card operations.

Fraud

1. Evaluate management's strategy for controlling fraud, including whether the strategies frequently emphasize review of credit card applications to prevent fraudulent accounts from being booked or whether neural networks are used to identify fraudulent transactions. Common controls include the following items:
   a. methods of preventing application fraud, such as name and address verification, duplicate-application detection, Social Security number verification, etc.
   b. physical aspects of cards such as holograms and enriched information on the magnetic stripe
   c. adequate staffing and training of the fraud-detection department
   d. computer systems to identify suspicious activity
   e. procedures for issuing cards to prevent their interception and activation
   f. procedures for handling returned cards, statements, PINs, checks, and lost and stolen cards
   g. investigation and documentation of cases of suspected fraud
   h. freezing of accounts with suspicious activity
   i. procedures for filing a Suspicious Activity Report (See the FFIEC BSA/AML Examination Manual), the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).)
   j. procedures for access to and alteration of customer information
   k. controls over cardholder payments, account-balance records, and chargeback administration
   l. account-authorization procedures
2. Determine whether management receives adequate fraud-monitoring reports, such as—
   a. out-of-pattern-purchase or sequence-of-purchase reports that identify suspicious transactions that do not fit an individual cardholder's established purchasing pattern or
   b. suspicious-purchasing-pattern reports that identify certain types of purchases, such

as electronics or jewelry, that can correlate with fraudulent activity.

3. Review consumer complaint correspondence from cardholders that is on file with the bank or primary federal regulator for irregularities or patterns of activity.

Account Solicitation

1. Determine management's general approach to account solicitations (a variety of approaches or a combination of approaches can exist). Solicitations may be for preapproved or non-preapproved accounts. The latter are usually solicited through mass mailings, telemarketing, or counter displays.
2. Determine the extent to which outside contractors are used in marketing programs (for example, outsourced mass-mailing and telemarketing operations).
3. Review management's product and marketing program, including the goals of the program, the basis of the marketing approach, and product pricing. Ascertain whether adequate supporting evidence exists to indicate (1) that management has a marketing program and a product that appeal to the bank's targeted markets and (2) that the projected product and marketing program results will be obtained.
4. Determine how management identifies markets for new solicitations and evaluates expected performance.
   a. Identify the analytical procedures (for example, response rates, usage rates, credit-score distributions, and future delinquency and loss rates) management uses to project the results of a particular solicitation.
   b. Determine how management verifies projections before proceeding with a full-scale solicitation program (test marketing).
5. Determine if management monitors solicitation results for each major account segment and if management incorporates the findings into future solicitations.
6. Determine if management monitors and responds to trends in adverse selection (such as when a disproportionate number of respondents that are poor credit risks answer an offer, which may result in a larger-than-projected percentage of riskier accounts being including in the solicitation-response pool).
7. Review affinity and co-branding relationships. Determine if the bank has control over the approval and acceptance of such accounts. (In co-branding, a third-party relationship exists between a broad base of cardholders and a jointly sponsored credit card. Usually, the sponsors are the bank and a retail merchant for the affinity and co-branding relationships. These cards have some type of value-added feature such as cash rebates or discounts on merchandise.)
8. Review new-product offerings and the adequacy of management's market identification, testing, and ongoing monitoring of new products. Ascertain if management monitored and controlled key new-product concerns, including whether—
   a. the amount of historical and test-sample data available to analyze the product or solicitation was adequate;
   b. the speed at which the new product was introduced was compatible with the internal controls for credit authorizations; and
   c. the size of solicitations introduced was adequately controlled, considering operational and managerial capabilities.
9. Determine if management had any problems with the wording of solicitations or applications and if any imprecise offer terms contributed to asset-quality and earnings problems. Ascertain if there were errors such as the following:
   a. no expiration date on the offer
   b. an absence of wording giving management discretion in setting credit lines
   c. insufficient information requirements on applications
10. Review balance-transfer policies and monitoring practices. Determine if balance transfers generally resulted in higher credit exposures and a tendency to distort financial condition and performance ratios due to the immediate booking of relatively large balances.
11. Review teaser interest-rate practices. Determine if controls are adequate to prevent teaser rates from disguising a borrower's repayment capacity and from resulting in higher attrition when the teaser rates expire.

Predictive Models

1. Review the integrated models management uses to identify and select prospective customers. (Management usually uses two distinct credit card predictive models. The first model, the credit-scoring model, is used in the initial application process. The second model, a behavioral model, is used in the management of existing accounts. These models use a credit scorecard, which is a table of characteristics, attributes, and scores that enable a credit grantor to calculate default risk. Information derived from these models assists management with quantifying and minimizing credit risk and fraud losses.)

Credit Scoring

1. Determine the nature and extent that credit scores are used in the underwriting process.
2. Determine the degree of reliance placed on credit bureau score "good" and "bad" odds charts. Ascertain if management develops and calibrates its own good and bad odds chart with a sufficient quantity and quality of historical account data (a customized odds chart is more predictive than a credit bureau odds chart).
3. Determine if a single- or dual-score model is used. (A single-score model uses credit bureau scores; a dual-score matrix calculates a score based on the combination of a custom score, usually based on credit application data, and a credit bureau score. For the more complex operations, management should be using the more sophisticated dual-scoring model.)

Behavior-Scoring System

1. Determine whether management has implemented a behavior-scoring system to manage existing accounts. (The score is derived from a cardholder's payment and usage behavior with the credit cardholder's issuing bank. A cardholder's historical performance with a particular bank is typically the best indicator of future performance with that bank. Behavior scores are frequently supplemented with credit bureau scores to enhance their predictive value.)
2. Ascertain if management continually refines existing, or if it considers new, predictive models.
   a. Determine whether a champions and challengers system is used. (Such a system involves continual portfolio analysis and identification of predictive characteristics. Based on this analysis, existing models are revised and enhanced. The revised challenger model is then compared with the existing champion model. If the challenger is more predictive, it is adopted. This procedure is an ongoing system of refinement.)
   b. Determine if management has adopted or is considering new predictive models (for example, revenue, revolving, bankruptcy, and payment-predictor models).

Validation

1. If credit scoring is used, determine if management is validating scores by comparing account-quality rankings of accepted applications with those predicted by the system (when the rank orderings remain substantially the same, the scoring system remains valid).
   a. Review the statistical techniques used to validate each model used, and determine whether common statistical techniques are being used, such as the K/S test, the chi square, the goodness-of-fit test, divergence statistics, and the population stability test.
   b. Determine if high and low override controls are in place and if they are detailed on exception reports (overrides can skew a statistical population and distort analysis).

Portfolio Analysis

1. Review and analyze the bank's customized credit card reports, which usually include performance and industry peer-group analysis data (be alert to the possibility that the data may have been distorted by niche marketing, specialized card products, or extensive affiliate support).

2. Determine if management is segmenting portfolios (such as by geographic or demographic distribution, affinity relationship (cardholders belonging to a particular union, corporation, professional association, etc.), product type (premium or standard cards), or credit bureau scores). Consider the particular characteristics of each segment for delinquency, profitability, future marketing programs, ALLL calculations, and other purposes.
3. Determine whether geographic, customer-base, card-type, or other concentrations exist, and identify the unique risks posed by any of these portfolio segments or concentrations. Evaluate their degree of risk and consider mitigating factors.
4. Review how management uses portfolio information to identify developing trends, make strategic decisions, and detect potential problems.
   a. Determine how management reports identify the number and volume of workout and re-aged credits.[1]
   b. Evaluate the portfolio information that management reviews, such as asset-quality ratios and vintage analysis (an analysis of the account performance of homogeneous loans booked at a similar time using the same credit and pricing criteria).
5. Determine if cash advances are monitored and authorization procedures are in place (cardholders with excessive debt may obtain cash advances to pay other debts).
6. Review the level and trend of the following portfolio ratios:
   a. average balance of delinquent accounts (by 30-day time frames) to average balance of nondelinquent accounts
   b. lagged delinquency rate and nine-month net charge-offs to lag rates
   c. net charge-off rate and lagged net charge-off rate
   d. re-aged accounts and partial-payment plans to total active accounts and to average total loans
   e. total past-due loans to gross loans
   f. noncurrent loans to gross loans
7. Consider indicators of possible deterioration in asset quality and criticize prolonged practices that result in negative amortization (that is, when minimum payments consistently fall short of covering all finance charges and fees assessed during the billing cycle and when the outstanding balance continues to increase), inappropriate fees, and other practices that inordinately compound or protract consumer debt and disguise portfolio performance and quality. Be alert to other indicators and practices that can reflect a deterioration of asset quality, such as—
   a. rapid growth that may indicate a lowering of underwriting standards;
   b. lower minimum-payment requirements and extended principal-payment cycles, which may result in negative amortization and may also indicate less creditworthy accounts;
   c. a heightened ratio of total accounts being charged off to the number of accounts or a high average balance of accounts that may indicate a lax policy toward the number and level of credit lines granted to cardholders;
   d. lower payment rates combined with higher average balances, which may indicate that borrowers are having trouble paying their debt;
   e. an inordinately high ratio of income earned not collected on loans to total loans when compared with the percentage of total past-due loans to gross loans, which may indicate frequent re-agings, inadequate collection procedures, or a failure to charge off credit card receivables on a timely basis; and
   f. the average age of accounts, which may indicate that loss rates will rise for unseasoned accounts (loss rates are usually low for new offerings and peak at 18 to 24 months after issue).
8. Evaluate management's practices for cure programs, such as re-aging, loan extensions, deferrals, fixed payment, and forgiveness.

1. A workout is a former open-end credit card account in which credit availability has been closed and in which the balance owed has been placed on a fixed (dollar or percentage) repayment schedule in accordance with modified, concessionary terms and conditions. Generally, the repayment terms require amortization or liquidation of the balance owed over a defined payment period. Such arrangements are typically used when a customer is either unwilling or unable to repay the open-end credit card account in accordance with the original terms but shows the willingness and ability to repay the loan in accordance with modified terms and conditions. In a re-aged credit account, the bank changes the delinquency status of an account without the full collection of its delinquent payments.

9. Develop an overall assessment of the adequacy of a bank's account-management practices for its credit card lending business, incorporating the risk profile of the bank, the quality of management reporting, and the adequacy of the bank's charge-off policies and loss-allowance methodologies.
10. Evaluate whether the bank clearly documents in its policies and procedures the basis for using the exceptions to the FFIEC Uniform Retail Credit Classification and Account Management Policy and whether the bank documents the types of exceptions used and the circumstances giving rise to their use. Determine if the bank prudently limits the use of exceptions. If it does not, criticize the bank's management and require corrective action when the exceptions are not well managed, result in improper reporting, or mask delinquencies and losses.
11. Criticize management and recommend appropriate supervisory corrective action when workout programs are not managed properly (characteristics of improperly managed workout programs include workout programs that do not strive to have the borrowers repay credit card debt within 60 months, the existence of liberal repayment terms with extended amortizations, high charge-off rates, accounts being moved from one workout program to another, multiple re-agings, and poor MIS to monitor program performance).
12. Determine that the bank complies with the FFIEC Uniform Retail Credit Classification and Account Management Policy.
13. Determine whether management monitors and analyzes the performance of each workout program (whether the program achieves the objective of improving the borrower's subsequent performance, the effect of the program on delinquency ratios, etc.)
14. Assess the current and potential impact the workout programs have on reported performance and profitability, including their ALLL implications.
15. Determine if third parties purchase or fund loan payments to cure loan delinquencies and, if so, assess the impact.
16. Determine whether management developed contingent strategies to deal with rising delinquency levels, which are generally the first sign of account deterioration. Strategies could include the following issues:
    a. reviewing accounts more frequently
    b. decreasing the size of credit lines
    c. freezing or closing accounts
    d. increasing collection efforts
17. Ascertain the bank's compliance with its credit card policies and procedures by reviewing a sample of the bank's credit card loans that were originated since the prior examination.
18. Determine the level of classifications for credit card loans:
    a. Review a sample of loans to ascertain the accuracy and integrity of the bank's system for reporting past-due status.
    b. Verify that the bank's classification and charge-off procedures adhere to, at a minimum, the guidance of the FFIEC Uniform Retail Credit Classification and Account Management Policy.

Allowance for Loan and Lease Losses

1. Ascertain whether an allowance for loan and lease losses (ALLL) policy exists for credit card loans and if adequate ALLL analytical procedures are in place. Roll-rate analysis (analysis of the migration of an account from one billing cycle to the next), which is generally performed for each portfolio segment, is the industry standard. However, some banks use the following additional or alternative methods:
    a. delinquency analysis using a set percentage of loans over 60 days delinquent
    b. exposure analysis that projects net charge-off rates to each 30-day period of delinquency
    c. charge-off projections based on vintage analysis
    d. a historical rolling average based on charge-off rates for the last six months
    e. analysis based on external economic forecasting services
2. Review ALLL-calculation techniques for reasonableness (variables such as aggregating seasoned and unseasoned portfolios can significantly distort the calculation of required reserves).
3. Determine if ALLL calculations are comprehensive and if they consider the following factors:
    a. contingent liabilities, or the risk associated with undisbursed funds

b. bankrupt and deceased cardholders (such losses are usually not predicted by a simple roll-rate analysis)
c. economic conditions, such as unemployment and bankruptcy rates, that can significantly affect asset quality
d. the number and volume of workout and re-aged credits

4. Determine if the ALLL methodologies adequately provide for the use of cure programs, settlement arrangements,[2] workout programs, existing over-the limit portfolio segments, any resulting estimable probable losses on those accounts, and any other credit card loan accounts.
5. Review the accounting practices for crediting recoveries on credit card loans. Determine that the total amount credited to the ALLL as recoveries on individual credit card loans is limited to the amounts previously charged off against the ALLL for the credit card loan. Any excess recovery amount must be recognized as income.
6. Verify that fraud losses are not charged to the ALLL or included in ALLL calculations and that the losses are recorded as a noninterest expense.

Asset Securitization

Perform the following examination procedures when the bank has securitized its credit card receivables (removed designated credit card receivables from its balance sheet to a special-purpose vehicle (SPV) while the bank retains its account ownership).

1. Determine if the credit card loan delinquency and loss rates are similar for both the owned portfolio and the securitized portfolio. (Slightly higher delinquency and net charge-off ratios on securitized assets will be prevalent if the bank is experiencing high growth and possesses a significant portion of unseasoned accounts.) When the delinquency and loss rates deviate significantly, determine if management is prioritizing credit card receivables for securitization by selecting credit card accounts that have either a high credit quality or superior past credit history. For example, in the following two ratios, the resulting percentages on a managed and owned basis should approximate one another: (1) noncurrent loans to gross loans and (2) total past-due loans to gross loans.

2. Determine the on- and off-balance-sheet effects of asset securitization. (For example, what is the on- and off-balance-sheet effect of removing seasoned accounts?) (A performance analysis is important because the level of a credit card bank's earnings and capital is largely dependent on the quality of its average total assets under management and not merely on the owned credit card portfolio.)

Third Parties

1. Determine whether any credit card–related activities are outsourced. If so, complete the third parties review located in the Subprime Lending Loan Reference. Third parties may include brokers, marketing firms, collection or servicing firms, correspondents, affinity partners, and information systems firms.

2. Determine whether the bank shares a BIN (bank identification number) with a third party. (Sharing of BINs can create financial liability. A bank sharing a BIN should have a process to identify, monitor, and control the risks associated with BIN sharing. Certain Visa and MasterCard members are assigned BINs (represented by a series of numbers on the credit card) for clearing and settlement of their credit card activities. Members that are licensed specific BINs may allow other members to deposit and receive transactions through those BINs. However, the BIN licensee (holder of the BIN) has primary responsibility for transactions processed through its BIN. In addition, users of a BIN other than the BIN licensee (BIN holder) may share responsibility for transactions processed under that BIN if the licensee fails to meet its membership obligations.)

2. In a settlement arrangement, the bank forgives a portion of the amount owed. In exchange, the borrower agrees to pay the remaining balance either in a lump-sum payment or by amortizing the balance over several months.

BANK POLICIES AND PROCEDURES AND STATUTORY AND REGULATORY REQUIREMENTS

1. Determine compliance with laws, regulations, and Federal Reserve Board policies pertaining to lending by performing the following steps.
   a. *Lending limits:*
      - Determine the bank's lending limits as prescribed by state law.
      - Determine advances or combinations of advances whose aggregate balances are above the limit.

   b. *Sections 23A and 23B of the Federal Reserve Act (12 USC 371c and 371c-1) and the Federal Reserve's Regulation W—Transactions with Affiliates:*
      - Obtain a listing of loans and other extensions of credit to affiliates.
      - Test-check the listing against the bank's customer liability records to determine the list's accuracy and completeness.
      - Obtain a listing of other covered transactions with affiliates (i.e., purchase of an investment or securities issued by an affiliate; purchase of loans or other credit-related assets, including assets subject to an agreement to repurchase from an affiliate; the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate; or acceptance of affiliate's securities as collateral for a loan to any person).
      - Determine the volume of transactions with third parties when the proceeds were used or transferred for the benefit of any affiliate.
      - Ensure that covered transactions with affiliates do not exceed the limits of section 23A.
      - Ensure that covered transactions with affiliates meet the collateral requirements of section 23A.
      - Determine that low-quality loans or other assets have not been purchased from an affiliate.
      - Determine that all transactions with affiliates are on market terms and conditions that are consistent with safe and sound banking practices.
      - Determine that the transactions were conducted on terms and conditions that reflect pricing that is generally available to unaffiliated parties.

   c. *18 USC 215—Commission or Gift for Procuring Loan:*
      - While examining the installment loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
      - Investigate any such suspected situation.

   d. *Federal Election Campaign Act (2 USC 441b)—Political Contributions:*
      - While examining the installment loan area, determine the existence of any loans in connection with any election to any political office.
      - Review each such credit to determine whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.

   e. *12 USC 1972—Tie-In Provisions.* While reviewing credit and collateral files (especially loan agreements), determine whether any extension of credit is conditioned upon the customer's—
      - obtaining additional credit, property, or services from the bank, other than a loan, discount, deposit, or trust service;
      - obtaining additional credit, property, or service from the bank's parent holding company or the parent's other subsidiaries;
      - providing an additional credit, property, or service to the bank, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service;
      - providing additional credit, property, or service to the bank's parent holding company or any of the parent's other subsidiaries; or
      - not obtaining other credit, property, or service from a competitor of the bank, the bank's parent holding company, or the parent's other subsidiaries, except that the lending bank may impose conditions and requirements in a credit transaction to ensure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider activities and reporting requirements are as follows (the examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment):
   - *Regulation O (12 CFR 215)—Loans to Executive Officers, Directors, and Principal Shareholders and Their Interests.* While reviewing information relating to insiders received from the bank or appropriate examiner (including information on loan participations, loans purchased and sold, and loan swaps)—
     - — Test the accuracy and completeness of information about installment loans by comparing it with the trial balance or loans sampled.
     - — Review credit files on insider loans to determine that required information is available.
     - — Determine that loans to insiders do not contain terms more favorable than those afforded to other borrowers.
     - — Determine that loans to insiders do not involve more than the normal risk of repayment or present other unfavorable features.
     - — Determine that loans to insiders, as defined by the various sections of Regulation O, do not exceed the lending limits imposed by those sections.
     - — If prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained.
     - — Determine compliance with the various reporting requirements for insider loans.
     - — Determine that the bank has made provisions to comply with the public disclosure requirements for insider loans.
     - — Determine that the bank maintains records of such public requests and the disposition of the requests for a period of two years.
   - *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2))—Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
     - — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
     - — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *Federal Reserve Board Policy Statement on the Disposition of Credit Life Insurance Income (67* Fed. Res. Bull. *431 (1981), FRRS 3–1556).* Test for compliance with the policy statement by determining—
   - that the income generated from the sale of credit life, health, and accident insurance[3] is—
     - — not distributed directly to employees, officers, directors, or principal shareholders in the form of commissions or other income for their personal profit; however, such individuals may participate in a bonus or incentive plan in an amount not exceeding, in any one year, 5 percent of the recipient's annual salary, and paid not more often than quarterly; and
     - — for accounting purposes, credited to the bank's income account, the income account of an affiliate operating under the Bank Holding Company Act, or in the case of an individual shareholder, to a trust for the benefit of all shareholders.
   - whether an insurance agent or agency acted as an intermediary in arranging the bank's credit life insurance coverage and what the relationship of the agent or agency is to the bank. Is the agent or agency in compliance with the provisions of this policy?

3. This policy also applies to income derived from the sale of mortgage life insurance; therefore, consult with the examiner assigned real estate loans to coordinate work to avoid any duplication of efforts.

- which employees, officers, directors. and principal shareholders are licensed insurance agents.
- whether bank officers have entered into reciprocal arrangements with officers of other banks to act as agent for sale of credit life insurance and to receive commissions.
- if the credit life insurance income is credited to an entity other than the bank and whether the bank is being appropriately reimbursed for the use of its premises, personnel, and goodwill. Compute the percentage compensation paid to the bank (total credit life insurance income). Include that percentage in the confidential section of the commercial report of examination. As a general rule, a reasonable compensation would be an amount equivalent to at least 20 percent of the credited entity's *net* income (if available) attributable to the credit life insurance sales.

h. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 1010.410)—Records to Be Retained by Financial Institutions.* Review operating procedures and credit life documentation and determine whether the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date therefor. Loans secured by an interest in real property are exempt.

2. Perform appropriate procedural steps for the separate area, concentration of credits.
3. Discuss with the appropriate officer (or officers) and prepare comments to the examiner-in-charge stating your findings on the following:
   a. delinquent loans, including breakout of "A" paper
   b. violations of laws and regulations
   c. concentration of credits
   d. classified loans
   e. loans not supported by current and complete financial information
   f. loans on which collateral documentation is deficient
   g. inadequately collateralized loans
   h. extensions of credit to major stockholders, employees, officers, directors, and/or their interests
   i. Small Business Administration or other government-guaranteed delinquent or criticized loans
   j. a list of installment loans requested to be charged off
   k. the adequacy of written policies relating to installment loans
   l. the manner in which bank officers are operating in conformance with established policy
   m. adverse trends within the installment area
   n. the accuracy and completeness of the schedules obtained from the bank or other examination areas
   o. internal-control deficiencies or exceptions
   p. recommended corrective action when policies, practices, or procedures are deficient
   q. the quality of departmental management
   r. other matters of significance
4. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing installment loans. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. In the questionnaire below, items marked with an asterisk require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written installment-loan policies that establish—
   a. procedures for reviewing installment-loan applications?
   b. standards for determining credit lines?
   c. minimum standards for documentation?
2. Are installment-loan policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Does the bank have adequate written overdraft-protection-program policies and procedures that follow the February 28, 2005, interagency Joint Guidance on Overdraft Protection Programs?
4. Does the bank's management emphasize and monitor adherence to its overdraft policies and procedures, apply generally accepted accounting principles, and apply the bank Call Report's accounting and reporting requirements to overdrafts? Does the bank maintain and monitor safe and sound overdraft business practices to control the credit, operational, and other risks associated with overdraft programs?

RECORDS

*1. Is the preparation and posting of subsidiary installment-loan records performed or reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?

*2. Are the subsidiary installment-loan records reconciled daily to the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?

3. Are delinquent-account collection requests and past-due notices checked to the trial balances that are used in reconciling installment-loan subsidiary records to general ledger accounts, and are requests and notices handled only by persons who do not also handle cash?

4. Are loan-balance inquiries received and investigated by persons who do not also handle cash?

*5. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash? (If not, explain why briefly.)

6. Is a daily record maintained that summarizes loan-transaction details, i.e., loans made, payments received, and interest collected, to support applicable general ledger account entries?

7. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?

8. Are two authorized signatures required to effect a status change in an individual customer's account?

9. Does operating management produce and review an exception report that encompasses extensions, renewals, or any factors that would result in a change in a customer's account status?

10. Do customer account records clearly indicate accounts that have been renewed or extended?

LOAN INTEREST

1. Is the preparation and posting of interest records performed or reviewed by persons who do not also—
   a. issue official checks or drafts?
   b. handle cash?
2. Are any independent tests of loan-interest computations made and compared with initial and subsequent borrowers' interest records by other persons who do not—
   a. issue official checks or drafts?
   b. handle cash?

COLLATERAL

1. Are multicopy, prenumbered records maintained that—
   a. detail the complete description of collateral pledged?
   b. are typed or completed in ink?
   c. are signed by the customer?
2. Are receipts issued to customers for each item of collateral deposited?
3. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
4. Is negotiable collateral held under joint custody?
5. Is all collateral for a single loan maintained in a separate file?
6. Are receipts obtained and filed for released collateral?
7. Is a record maintained of entry to the collateral vault?
8. Are the following controls on collateral in effect:
   a. When the bank customers' savings passbooks are held as collateral, the savings department is notified and the account is so noted on the deposit ledger.
   b. Descriptions of motor vehicles, as set forth on the certificate of title and insurance policies, are checked to the chattel mortgages or other appropriate documents granting security interest in the vehicle.
   c. An insurance-maturity tickler file is maintained.
   d. Procedures are in effect to ensure single-interest insurance coverage is obtained in case regular insurance is canceled or expires.
   e. All insurance policies on file include a loss-payable clause in favor of the bank.
   f. Filings are made on all security agreements.
   g. Supporting lien searches and property appraisals are performed when a judgment action is returned involving real property.
9. Are control records maintained that identify loans secured by junior liens on real estate?
10. Do those records indicate the current balance for loans secured by superior liens on the same property?

DEALER LOANS

1. On dealer loans, are—
   a. separate controls maintained or can they be easily generated?
   b. payments made directly to the bank and not through the dealer?
   c. coupon books, if used in connection with loans, mailed to the borrowers, instead of the dealer?
   d. monthly summaries of the total paper discounted and outstanding for each dealer prepared and reviewed?
   e. dealer lines reaffirmed at least annually?
   f. required documents on file in connection with the establishment of each dealer line?
   g. signed extension agreements obtained from dealers before extending accounts originally discounted on a repurchase agreement or other recourse basis?
   h. downpayment amounts checked to ensure they do not misrepresent the sales price?
   i. procedures in effect to prevent the dealer from making late payments?
   j. prohibitions against bringing loans current by charges to the dealer's reserve accounts in effect?
   k. selling prices, as listed by the dealer, verified?
   l. overdrafts prohibited in the dealer reserve and holdback accounts?
   m. procedures in effect to have the title application controlled by someone other than the purchaser?
   n. credit checks on borrowers performed independently of the dealer, or are the dealer's credit checks independently verified?
   o. delinquencies verified directly with the customers?

DISCOUNTED LEASING PAPER

1. If the bank discounts leasing paper—
   a. are separate controls maintained or can they be easily generated?
   b. are payments made directly to the bank?
   c. are controls established or are audits of lessor's books conducted if the lessor is permitted to accept payments (if so, explain why briefly)?
   d. are monthly summaries of total paper

discounted for each lessor prepared and reviewed?
e. are lines for each lessor reaffirmed at least annually?
f. is a master lease required and properly recorded when fleet-leasing or blanket purchase of leasing paper is handled?
g. is the value of leased goods verified to ensure that it is not less than the amount advanced?
h. is lease paper screened for the credit quality of the lessee?
i. are lease terms and payment amounts required to be adequate to liquidate the debt in full?

CREDIT CARD LENDING

1. Has the bank tested, analyzed, and documented line-assignment and line-increase criteria prior to broad implementation of a new credit card plan?
2. Is a borrower's repayment capacity carefully considered when the bank assigns an initial credit line or significantly increases existing credit lines?
   a. Are credit-line assignments managed conservatively using proven credit criteria?
   b. Does the bank have documentation and analyses of decision factors such as repayment history, risk scores, behavior scores, or other relevant criteria?
   c. Does the bank consider its entire relationship with a borrower when making decisions about credit-line assignments?
   d. If the bank offers multiple credit lines to borrowers, does it have sufficient controls and management information systems to aggregate related exposures and analyze borrowers' performance before offering them additional lines of credit?
3. Do the bank's policies and procedures focus on adequate control, authorizations, and the timely repayment of amounts that exceed established credit limits?
   a. Are the bank's management information systems sufficient to enable management to identify, measure, manage, and control the risks associated with over-limit accounts?
   b. Does the bank have appropriate policies and controls for over-limit authorizations on open-end accounts, particularly subprime accounts?
4. Do the bank's policies and procedures require that minimum payments on credit card accounts amortize the current balances over a reasonable period of time, consistent with the nature of the underlying debt and the borrower's documented creditworthiness? Do the bank's policies and practices foster or encourage prolonged negative amortization, inappropriate fees, and other practices that inordinately compound or protract consumer debt?
5. Are workout programs designed to maximize principal reduction, and do they strive to have borrowers repay their credit card debt within 60 months? Has the bank documented and supported, with compelling evidence, any exceptions to the 60-month time frame for workout programs? Has the bank also documented and supported any less conservative loan terms and conditions that may be warranted?
6. Has the bank established and maintained adequate loss allowances for credit card accounts subject to settlement arrangements?
   a. Does the bank classify as a loss and charge off immediately amounts of debt forgiven in settlement arrangements?
   b. Are specific allowances for such settlement accounts reported as a charge-off in Schedule RI-B of the call report?
   c. Does the bank charge off any deficiency balances within 30 days from the receipt of a final settlement payment?
7. Does the bank evaluate the collectibility of accrued interest and fees on credit card accounts and recognize and properly account for the amounts that are uncollectible?
   a. Are appropriate methods employed to ensure that income is accurately measured (such methods include providing loan-loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status)?
   b. Is the owned portion of accrued interest and fees, including related estimated losses, accounted for separately from the retained interest in accrued interest and fees from securitized credit card receivables?
8. Does the bank's allowance for loan and lease losses (ALLL) methodology fully recognize the incremental losses that may be inherent in over-limit accounts and portfolio segments?

9. Are accounts in workout programs segregated for performance-measurement, impairment-analysis, and monitoring purposes?
   a. Are multiple workout programs with different performance characteristics tracked separately?
   b. Is the allowance allocation for each workout program equal to the estimated loss in each program, based on historical experience adjusted for current conditions and trends?
10. Is the total amount credited to the ALLL as recoveries on a loan limited to the amount previously charged off against the ALLL, and are any amounts that are collected in excess of this limit recognized as income?
11. Do the bank's policies and procedures address the types of allowed exceptions to the FFIEC's Uniform Retail Credit Classification and Account Management Policy and also the circumstances permitting those exceptions?
    a. Is the volume of accounts that are granted exceptions small and well controlled?
    b. Is the performance of accounts that are granted exceptions closely monitored?
    c. Does the bank use exceptions prudently? If not, has management been criticized and has appropriate supervisory corrective action been recommended?

REPOSSESSIONS

1. Are procedures established on repossessions so that—
   a. management takes timely action to receive full advantage of any dealer endorsement or repurchase agreement?
   b. the notice of intention to sell is mailed to all parties who are liable on the account?
   c. bids are required before the sale of the item?
   d. bids are retained in the borrower's credit file?
   e. open repossessions are physically checked monthly?
   f. surplus funds received from the sale of a repossession are mailed back to the borrower in the form of a cashier's check?
   g. any deficiency balance remaining after the sale of repossession is charged off?
   h. the bill of sale is properly completed and signed by an officer?
   i. separate general ledger control is maintained?

DELINQUENT ACCOUNTS AND OPERATING REVIEW SYSTEM

1. Are collection policies established so that—
   a. a delinquent notice is sent before a loan becomes 30 days past due?
   b. collection effort is intensified when a loan becomes two payments past due?
   c. records of collection efforts are maintained in the customer's file?
   d. field or outside collectors are under the supervision of an officer and are required to submit progress reports?
   e. all collections are acknowledged on multicopy prenumbered forms?
   f. all documents that are held outside the regular files and that pertain to installment loans under collection are evidenced by a transmittal sheet and receipt?
   g. delinquency lists are generated on a timely basis (indicate the frequency)?
2. Is an operating review system in place that—
   a. determines that duties are properly segregated and that loan officers are prohibited from processing loan payments?
   b. recomputes the amount of credit life and accident and health insurance on new loans?
   c. recomputes the amount of discount on new loans?
   d. recomputes the rebates on prepaid loans?
   e. test-checks daily transactions to subsequent general ledger postings?
   f. reviews new-loan documentation?
   g. reviews all information in reports being submitted to the board of directors, or any committee thereof, for errors or omissions?
   h. conducts a periodic review of income accruals for accuracy?
   i. reviews entries to unearned discount or income accounts?
   j. reviews all charged-off loans for proper approval?
   k. periodically reconciles charged-off notes to controls?

l. reviews dealer's reserve and holdback agreements and periodically determines the adequacy of the balances in the deposit account?

m. periodically verifies dealer reserve balances?

n. determines that payments are accurately and promptly posted?

o. reviews collection or reversal of late charges?

p. determines that extension fees are collected on all extended loans?

q. determines that discounted dealer paper is properly endorsed?

r. determines that discounted dealer paper is within established guidelines?

s. reviews compliance with laws and regulations?

t. reviews trial balance reconcilements to the general ledger?

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control that is, 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.
2. On the basis of a composite evaluation (as evidenced by answers to the foregoing questions), is internal control considered adequate or inadequate?

Federally insured banks tend to avoid lending to customers with poor credit histories because of the higher risk of default and resulting loan losses. However, some lenders[1] extend their risk-selection standards to attract lower-credit-quality accounts.

Subprime lending involves extending credit to borrowers who exhibit characteristics that indicate a significantly higher risk of default than traditional bank lending customers.[2] The risk of default may be measured by traditional credit-risk measures (such as credit or repayment history or debt-to-income levels) or by alternative measures such as credit scores.

Subprime borrowers represent a broad spectrum of debtors, ranging from those who have repayment problems because of an adverse event, such as job loss or medical emergency, to those who persistently mismanage their finances and debt obligations. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Generally, subprime borrowers will display a range of one or more credit-risk characteristics, such as—

- two or more 30-day delinquencies in the last 12 months, or one or more 60-day delinquencies in the last 24 months;
- judgment, foreclosure, repossession, or charge-off in the prior 24 months;
- bankruptcy in the last five years;
- relatively high default probability as evidenced by, for example, a credit bureau risk score (FICO) of 660 or below (depending on the product or collateral), or other bureau or proprietary scores with an equivalent default-probability likelihood; or
- debt-service-to-income ratio of 50 percent or greater, or an otherwise limited ability to cover family living expenses after deducting total monthly debt-service requirements from monthly income.

Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

SUPERVISORY GUIDANCE FOR SUBPRIME LENDING

The subprime supervisory guidance applies to direct extensions of credit; the purchase of subprime loans from other lenders, including delinquent or credit-impaired loans purchased at a discount; the purchase of subprime automobile or other financing ‘‘paper’’ from lenders or dealers; and the purchase of loan companies that originate subprime loans.

Subprime lending does not include loans to borrowers who have had minor, temporary credit difficulties but are now current. Also, the subprime-lending guidance does not generally apply to prime loans that develop credit problems after acquisition; loans that were initially extended in subprime programs and are later upgraded, as a result of their performance, to programs targeted to prime borrowers; and community development loans, as defined in the Community Reinvestment Act (CRA) regulations, that may have some higher risk characteristics, but are otherwise mitigated by guarantees from government programs, private credit enhancements, or other appropriate risk-mitigation techniques.

Subprime lending poses unique and significant risks to banking institutions engaged in the activity. Market events have raised supervisory issues about how well subprime lenders are prepared to manage and control the risks. Subprime-lending institutions need strong risk-management practices and internal controls, as well as board-approved policies and procedures that appropriately identify, measure, monitor, and control all associated risks. Institutions considering or engaging in this type of lending should recognize the additional risks inherent in this activity and determine if these risks are acceptable and controllable, given their organization’s financial condition, asset size, level of capital support, and staff size. Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well

1. The terms *lenders*, *financial institutions*, and *institutions* refer to federally insured banks and their subsidiaries.
2. For purposes of this section, loans to customers who are not subprime borrowers are referred to as *prime*.

before the time frames in their respective interagency supervisory policy.

Interagency guidance on subprime lending was issued on March 1, 1999, to alert examiners and financial institutions to some of the pitfalls and hazards involved in this type of lending.[3] (See SR-99-06.) Additional interagency examination guidance was issued on January 31, 2001, to further strengthen the supervision of certain institutions, primarily those institutions having subprime-lending programs with an aggregate credit exposure equaling or exceeding 25 percent of their tier 1 capital.[4] (See SR-01-04.) The aggregate exposure includes principal outstanding and committed, accrued and unpaid interest, and any retained residual interests[5] relating to securitized subprime loans. The Federal Reserve may also apply the additional guidelines to certain smaller subprime portfolios, such as those experiencing rapid growth or adverse performance trends, those administered by inexperienced management, and those with inadequate or weak controls.

Subprime loans command higher interest rates and loan fees than those offered to standard-risk borrowers. Subprime loans can be profitable, provided the price charged by the lender is sufficient to cover higher loan-loss rates and overhead costs related to underwriting, servicing, and collecting the loans. The ability to securitize and sell subprime portfolios at a profit while retaining the servicing rights makes subprime lending attractive to a larger number of institutions, further increasing the number of subprime lenders and loans. Some financial institutions have experienced losses attributable to ill-advised or poorly structured subprime-lending programs. These losses have attracted greater supervisory attention to subprime lending and the ability of an insured bank to manage the unique risks associated with this activity.

3. The March 1999 and January 2001 statements were adopted and issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

4. The March 1999 and January 2001 subprime-lending interagency guidance is consolidated within this section. To focus on the supervisory guidance that applies primarily to institutions having subprime-lending programs equaling or exceeding 25 percent of tier 1 capital, see the January 2001 release. The March 1999 interagency supervisory guidance applies to all subprime-lending institutions.

5. Residual interests are on-balance-sheet assets that represent interests (including beneficial interests) in transferred financial assets retained by a seller (or transferor) after a securitization or other transfer of financial assets. They are structured to absorb more than a pro rata share of credit loss related to the transferred assets through subordination provisions or other credit-enhancement techniques.

Risk Management

The following items are essential components of a well-structured risk-management program for subprime lenders.

Planning and Strategy

Before engaging in subprime lending, the board and management should ensure that proposed activities are consistent with the institution's overall business strategy and risk tolerances, and that all involved parties have properly acknowledged and addressed critical business-risk issues. These issues include the costs associated with attracting and retaining qualified personnel, investments in the technology necessary to manage a more complex portfolio, a clear solicitation and origination strategy that allows for after-the-fact assessment of underwriting performance, and the establishment of appropriate feedback and control systems. The risk-assessment process should extend beyond credit risk and appropriately incorporate operating, compliance, and legal risks. Finally, the planning process should set clear objectives for performance, including the identification and segmentation of target markets or customers, as well as set performance expectations and benchmarks for each segment and the portfolio as a whole. Institutions establishing a subprime-lending program should proceed slowly and cautiously into this activity to minimize the impact of unforeseen personnel, technology, or internal-control problems and to determine if favorable initial profitability estimates are realistic and sustainable.

Staff Expertise

Subprime lending requires specialized knowledge and skills that many financial institutions may not possess. Marketing, account-origination, and collections strategies and techniques often differ from those employed for prime credit; thus, it may not be sufficient to have the same lending staff responsible for both subprime loans and other loans. Additionally, servicing and collecting subprime loans can be very labor intensive. If necessary, the institution should implement programs to train staff. The board should ensure that staff possess sufficient expertise to appropriately manage the risks in subprime lending and that staffing levels are adequate for the planned volume of subprime activity. The experience, or seasoning, of staff and loans should be taken into account as performance is assessed over time.

Lending Policy

A subprime-lending policy should be appropriate to the size and complexity of the institution's operations and should clearly state the goals of the subprime-lending program. While not exhaustive, the following lending standards should be addressed in any subprime-lending policy:

- types of products offered as well as those that are not authorized
- portfolio targets and limits for each credit grade or class
- lending and investment authority clearly stated for individual officers, supervisors, and loan committees
- a framework for pricing decisions and profitability analysis that considers all costs associated with the loan, including origination costs, administrative or servicing costs, expected charge-offs, and capital
- evaluation of collateral and appraisal standards
- well-defined and specific underwriting parameters (that is, on acceptable loan term, debt-to-income ratios, and loan-to-collateral-value ratios for each credit grade and a minimum acceptable credit score) that are consistent with any applicable supervisory guidelines[6]
- procedures for the separate tracking and monitoring of loans approved as exceptions to stated policy guidelines
- credit-file documentation requirements, such as applications, offering sheets, loan and collateral documents, financial statements, credit reports, and credit memoranda to support the loan decision
- correspondent/broker/dealer approval process, including measures to ensure that loans originated through this process meet the institution's lending standards

If the institution elects to use credit scoring (including applications scoring) for approvals or pricing, the scoring model should be based on a development population that captures the behavioral and credit characteristics of the subprime population targeted for the products offered. Because of the significant variance in characteristics between the subprime and prime populations, institutions should not rely on models developed solely for products offered to prime borrowers. Further, the model should be reviewed frequently and updated as necessary to ensure that assumptions remain valid.

Purchase Evaluation

As they evaluate expected profits, institutions that purchase subprime loans from other lenders or dealers must give due consideration to the cost of servicing these assets and to the loan losses that may be experienced. For instance, some lenders who sell subprime loans charge borrowers high up-front fees, which are usually financed into the loan. This provides incentive for originators to produce a high volume of loans with little emphasis on quality, to the detriment of a potential purchaser. Further, subprime loans, especially those purchased from outside the institution's lending area, are at special risk for fraud or misrepresentation (that is, the quality of the loan may be less than the loan documents indicate).

Institutions should perform a thorough due-diligence review before committing to purchase subprime loans. Institutions should not accept loans from originators that do not meet their underwriting criteria, and they should regularly review loans offered to ensure that loans purchased continue to meet those criteria. Deterioration in the quality of purchased loans or in the portfolio's actual performance versus expectations requires a thorough reevaluation of the lenders or dealers who originated or sold the loans, as well as a reevaluation of the institution's criteria for underwriting loans and selecting dealers and lenders. Any such deterioration may also highlight the need to modify or termi-

6. Extensions of credit secured by real estate, whether the credit is subprime or otherwise, are subject to the Interagency Guidelines for Real Estate Lending Policies, which establish supervisory loan-to-value (LTV) limits on various types of real estate loans and impose limits on an institution's aggregate investment in loans that exceed the supervisory LTV limits. (See 12 CFR 208, appendix C.)

nate the correspondent relationship or to adjust underwriting and dealer or lender selection criteria.

Loan-Administration Procedures

After the loan is made or purchased, loan-administration procedures should provide for the diligent monitoring of loan performance and establish sound collection efforts. To minimize loan losses, successful subprime lenders have historically employed stronger collection efforts, such as calling delinquent borrowers frequently, investing in technology (for example, using automatic dialing for follow-up telephone calls on delinquent accounts), assigning more experienced collection personnel to seriously delinquent accounts, moving quickly to foreclose or repossess collateral, and allowing few loan extensions. This aspect of subprime lending is very labor intensive but critical to the program's success. To a large extent, the cost of such efforts can be a tradeoff with future loss expectations, when an institution analyzes the profitability of subprime lending and assesses its appetite to expand or continue this line of business. Subprime-loan administration procedures should be in writing and at a minimum should detail—

- billing and statement procedures;
- collection procedures;
- content, format, and frequency of management reports;
- asset-classification criteria;
- methodology to evaluate the adequacy of the allowance for loan and lease losses (ALLL);
- criteria for allowing loan extensions, deferrals, and re-agings;
- foreclosure and repossession policies and procedures; and
- loss-recognition policies and procedures.

Loan Review and Monitoring

Once an institution books the loans, designated staff must perform an ongoing analysis of subprime loans, not only on an aggregate basis but also for subportfolios. Information systems should be in place to segment and stratify the institution's portfolio (for example, by originator, loan-to-value, debt-to-income ratios, or credit scores). Assigned staff should produce reports that management can use to evaluate the performance of subprime loans. The review process should focus on whether performance meets expectations. Institutions then need to consider the source and characteristics of loans that do not meet expectations and make changes in their underwriting policies and loan-administration procedures to restore performance to acceptable levels.

When evaluating actual performance against expectations, it is particularly important that management review credit scoring, pricing, and any ALLL-adequacy models. Models driven by the volume and severity of historical losses experienced during an economic expansion may have little relevance in an economic slowdown, particularly in the subprime market. Management should ensure that models used to estimate credit losses or to set pricing allow for fluctuations in the economic cycle and are adjusted to account for other unexpected events.

Consumer Protection

Institutions that originate or purchase subprime loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Higher fees and interest rates combined with compensation incentives can foster predatory pricing or discriminatory "steering" of borrowers to subprime products for reasons other than the borrower's underlying creditworthiness. An adequate compliance-management program must identify, monitor, and control the consumer protection hazards associated with subprime lending.

Subprime mortgage lending may trigger the special protections of the Home Ownership and Equity Protection Act of 1994, subtitle B of title I of the Riegle Community Development and Regulatory Improvement Act of 1994. This act amended the Truth in Lending Act to provide certain consumer protections in transactions involving a class of nonpurchase, closed-end home mortgage loans. Institutions engaging in this type of lending must also be thoroughly familiar with the obligations set forth in Regulation Z (12 CFR 226.32), Regulation X (24 CFR 3500), and the Real Estate Settlement Procedures Act (RESPA) (12 USC 2601) and should adopt policies and implement practices that ensure compliance.

The Equal Credit Opportunity Act makes it unlawful for a creditor to discriminate against an applicant on a prohibited basis regarding any aspect of a credit transaction. Similarly, the Fair Housing Act prohibits discrimination in connection with residential real estate–related transactions. Loan officers and brokers must treat all similarly situated applicants equally and without regard to any prohibited-basis characteristic (for example, race, sex, or age). This is especially important with respect to how loan officers or brokers assist customers in preparing their applications or otherwise help them to qualify for loan approval.

Securitization and Sale

To increase their loan-production and -servicing income, some subprime lenders originate loans and then securitize and sell them in the asset-backed securities market. Strong demand from investors and favorable accounting rules often allow securitization pools to be sold at a gain, providing further incentive for lenders to expand their subprime-lending program. However, the securitization of subprime loans carries inherent risks, including interim credit risk and liquidity risks, which are potentially greater than those for securitizing prime loans. Accounting for the sale of subprime pools requires assumptions that can be difficult to quantify, and erroneous assumptions could lead to the significant overstatement of an institution's assets. Moreover, the practice of providing support and substituting performing loans for nonperforming loans to maintain the desired level of performance on securitized pools has the effect of masking credit-quality problems.

Institutions should recognize the volatility of the secondary market for subprime loans and the significant liquidity risk incurred when originating a large volume of loans intended for securitization and sale. Investors can quickly lose their appetite for risk in an economic downturn or when financial markets become volatile. As a result, institutions that have originated, but have not yet sold, pools of subprime loans may be forced to sell the pools at deep discounts. If an institution lacks adequate personnel, risk-management procedures, or capital support to hold subprime loans that were originally intended for sale, these loans may strain an institution's liquidity, asset quality, earnings, and capital. Consequently, institutions actively involved in the securitization and sale of subprime loans should develop a contingency plan that addresses backup purchasers of the securities or the attendant servicing functions, alternate funding sources, and measures for raising additional capital.

Institutions should refer to the Statement of Financial Accounting Standards No. 140 (FAS 140), "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities," for guidance on accounting for these transactions. If a securitization transaction meets FAS 140 sale or servicing criteria, the seller must recognize any gain or loss on the sale of the pool immediately and carry any retained interests in the assets sold (including servicing rights or obligations and interest-only strips) at fair value. Management should ensure that the key assumptions used to value these retained interests are reasonable and well supported, both for the initial valuation and for subsequent quarterly revaluations. In particular, management should consider the appropriate discount rates, credit-loss rates, and prepayment rates associated with subprime pools when valuing these assets. Since the relative importance of each assumption varies with the underlying characteristics of the product types, management should segment securitized assets by specific pool, as well as by predominant risk and cash-flow characteristics, when making the underlying valuation assumptions. In all cases, however, institutions should take a conservative approach when developing securitization assumptions and capitalizing expected future income from subprime-lending pools. Institutions should also consult with their auditors as necessary to ensure that their accounting for securitizations is accurate.

Reevaluation

Institutions should periodically evaluate whether the subprime-lending program has met profitability, risk, and performance goals. Whenever the program falls short of original objectives, an analysis should be performed to determine the cause, and the program should be modified appropriately. If the program falls far short of the institution's expectations, management should consider terminating it. Questions that management and the board need to ask may include the following:

- Have cost and profit projections been met?
- Have projected loss estimates been accurate?

- Has the institution been called upon to provide support to enhance the quality and performance of loan pools it has securitized?
- Were the risks inherent in subprime lending properly identified, measured, monitored, and controlled?
- Has the program met the credit needs of the community that it was designed to address?

Examination Review and Analysis

The following supervisory guidance (up to the examination objectives) applies only to banks that have subprime-lending programs equaling or exceeding 25 percent of tier 1 capital and to banks that have other designated subprime programs referenced in SR-01-4.

The heightened risk levels and potential volatility in delinquency and loss rates posed by subprime-lending programs warrant examiners' increased ongoing attention. The risks inherent in subprime-lending programs call for frequent reviews. There are generally two levels of review appropriate for subprime activities:

- *Portfolio-level reviews* include assessments of underwriting standards, marketing practices, pricing, management information and control systems (quality control, audit and loan review, vendor management, compliance), portfolio performance, and the appropriate application of regulatory and internal allowance and capital policies.
- *Transaction-level testing* includes the testing of individual loans for compliance with underwriting and loan-administration guidelines; the appropriate treatment of loans under delinquency, re-aging, and cure programs; and the appropriate application of regulatory and internal allowance and capital policies.

During each regularly scheduled examination cycle, examiners should perform a portfolio-level review and some transaction testing at each institution engaged in subprime lending. The Federal Reserve will perform regular off-site supervisory monitoring and may require subprime lenders to supply supplementary information about their subprime portfolios between examinations. The examiner's findings from transaction-level testing and portfolio-level reviews should be incorporated into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.

Transaction-Level Testing

Subprime-loan portfolios contain elevated risks, and actual subprime-lending practices often can deviate from stated policy and procedural guidance. Therefore, examiners should supplement the portfolio-level examination procedures with transaction-level testing to determine whether—

- individual loans adhere to existing policy, underwriting, risk-selection, and pricing standards;
- individual loans and portfolios are classified in accordance with the subprime-lending guidelines described in this section, or in other Federal Reserve credit-extending supervisory guidance;
- management, board, and regulatory reporting is accurate and timely;
- existing loans conform to specified account-management standards (such as over-limits, line increases, reductions, cancellations, re-scoring, or collections);
- key risk controls and control processes are adequate and functioning as intended;
- roll rates and other loss-forecasting methods used to determine ALLL levels are accurate and reliable; and
- lending practices exist that may appear unsafe, unsound, or abusive and unfair.

Adequacy of the ALLL

Examiners should assess the adequacy of the ALLL to ensure that the portion allocated to the subprime portfolio is sufficient to absorb estimated credit losses for this portfolio. Consistent with interagency policy,[7] the term *estimated credit losses* means an estimate of the amount that is not likely to be collected; that is, net charge-offs that are likely to be realized given the facts and circumstances as of the evaluation date.[8] These estimated losses should meet the

7. The 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses was issued December 13, 2006. (See SR-06-17.) The Supplemental Interagency policy statement on the ALLL methodologies and documentation was issued July 2, 2001. (See SR-01-07.)

8. Estimates of credit losses should include accrued interest and other accrued fees (for example, uncollected credit card

criteria for accrual of loss contingency, as set forth under generally accepted accounting principles (GAAP), consistent with supervisory ALLL policy.

New Entrants to the Business

In some instances, an institution (for example, a newly chartered institution or an existing institution entering the subprime-lending business) may not have sufficient previous loss experience to estimate an allowance for subprime-lending activities. In such cases, industry statistics or another institution's loss data for similar loans may be a better starting point to determine the ALLL than the institution's own data for developing loss rates. When an institution uses loss rates developed from industry statistics or from other institutions to determine its ALLL, it should demonstrate and document that the attributes of the loans in its portfolio or portfolio segment are similar to those in the other institution's (or industry's) portfolio.

Pools of Subprime Loans—Not Classified

The ALLL required for subprime loans should be sufficient to absorb at least all estimated credit losses on outstanding balances over the current operating cycle, typically 12 months. The board of directors and management are expected to ensure that the institution's process for determining an adequate level for the ALLL is based on a comprehensive and adequately documented analysis of all significant factors. The consideration factors should include historical loss experience, ratio analysis, peer-group analysis, and other quantitative analysis as a basis for the reasonableness of the ALLL. To the extent that the historical net charge-off rate is used to estimate expected credit losses, it should be adjusted for changes in trends, conditions, and other relevant factors, including business volume, underwriting, risk selection, account-management practices, and current economic or business conditions that may alter such experience. The allowance should represent a prudent, conservative estimate of losses that allows a reasonable margin for imprecision. Institutions should clearly document loss estimates and the allowance methodology in writing. This documentation should describe the analytical process used, including—

- portfolio-segmentation methods applied;
- loss-forecasting techniques and assumptions employed;
- definitions of terms used in ratios and model computations;
- relevance of the baseline loss information used;
- rationale for adjustments to historical experience; and
- a reconciliation of forecasted loss rates to actual loss rates, with significant variances explained.

Classification Guidelines for Subprime Lending

Well-managed subprime lenders should recognize the heightened loss characteristics in their portfolios and internally classify their delinquent accounts well before the time frames outlined in the retail classification policy issued by the Federal Financial Institutions Examination Council (FFIEC) on June 12, 2000. Examiners should classify subprime loans and portfolios in accordance with the guidelines in this section and other applicable Federal Reserve supervisory guidelines. Classified loans are loans that are not protected adequately by the current sound worth and paying capacity of the borrower or the collateral pledged. As such, full liquidation of the debt may be in jeopardy. Pools of classified subprime loans (to include, at a minimum, all loans past due 90 days or more) should be reviewed for impairment, and an adequate allowance should be established consistent with existing interagency policy.

Individual Loans

Examiners should not automatically classify or place loans in special mention merely because they are subprime. Rather, classifications should

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fees or uncollected late fees) that have been added to the loan balances and, as a result, are reported as part of the institution's loans on the balance sheet. An institution may include these types of estimated losses in either the ALLL or a separate valuation allowance, which would be netted against the aggregated loan balance for regulatory reporting purposes. When accrued interest and other accrued fees are not added to the loan balances and are not reported as part of loans on the balance sheet, the collectibility of these accrued amounts should nevertheless be evaluated to ensure that the institution's income is not overstated.

reflect the borrower's capacity and willingness to repay and the adequacy of collateral pledged.

Loans to borrowers that do not have the capacity to service their loans generally will be classified substandard. When repayment capacity is insufficient to support the orderly liquidation of the debt, and the collateral pledged is insufficient to mitigate risk of loss, then a more severe classification and nonaccrual is warranted. Subprime loans that are past due 90 days or more should be classified at least substandard based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay. A more stringent classification approach may be appropriate based on the historical loss experience of a particular institution. Classification of other subprime loans as doubtful or loss will be based on examiners' analysis of the borrower's capacity to repay, and on the quality of institution underwriting and account-management practices as evidenced in the loan file or by other documentation.

In some cases, the repayment of principal, interest, and fees on some subprime loans may be overly dependent on collateral pledged. This occurs when the risk of default is so high that an abundance of collateral is taken to mitigate risk of loss in the event of default. From a safety-and-soundness perspective, institutions should be discouraged from lending solely on the basis of collateral pledged. Such loans will generally be classified substandard. Further, when the borrower does not demonstrate the capacity to service the loan from sources other than collateral pledged, the loan may be placed on nonaccrual.

Portfolios

When the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality, examiners should consider classifying or criticizing the entire portfolio or segments of the portfolio. Such a decision may be appropriate in cases where risk is inordinately high or delinquency reports reflect performance problems. Some subprime-lending portfolios may pose very high risk. These may include portfolios of unsecured loans or secured, high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame. Most such portfolios should be classified at least substandard.

Required Documentation for Cure Programs

Cure programs, including such practices as re-aging, extensions, renewals, rewrites, or other types of account restructuring, are subject to the standards outlined in the retail classification policy. In accordance with that policy, cure programs should be used *only* when the institution has substantiated the customer's renewed willingness and ability to repay. Examiners will expect institutions to maintain documentation supporting their analysis of the customer's renewed ability and willingness to repay the loan at the time it is extended, renewed, or deferred. When the institution cannot demonstrate both the willingness and ability of the customer to repay, the loan should not be renewed, extended, deferred, or rewritten, and the loan should be moved back to its pre-cure delinquency status. Documentation should include one or more of the following:

- a new verification of employment
- a recomputed debt-to-income ratio indicating sufficient improvement in the borrower's financial condition to support orderly repayment
- a refreshed credit score or updated bureau report
- a file memo evidencing discussion with the customer

When documentation of the customer's renewed willingness and ability to repay the loan is absent or deficient, management practices should be criticized.

Predatory or Abusive Lending Practices

The term "subprime" is often misused to refer to certain predatory or abusive lending practices. Lending practices can be designed to responsibly provide service to customers and enhance credit access for borrowers with special credit needs. Subprime lending that is appropriately underwritten, priced, and administered can serve these goals.

Some forms of subprime lending may be abusive or predatory, however. Lending practices may be designed to transfer wealth from the borrower to the lender or loan originator without a commensurate exchange of value.

This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure or repossession to induce duress on the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:

- making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation
- inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced (that is, "loan flipping")
- engaging in fraud or deception to conceal the true nature of the loan obligation or ancillary products from an unsuspecting or unsophisticated borrower

Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the examination report as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to Federal Reserve consumer compliance/fair lending specialists for additional review.

Capitalization

The Federal Reserve's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles than those that exist in subprime-loan programs. Therefore, these requirements may not be sufficient to reflect the risks associated with subprime portfolios. Subprime-lending activities can present a greater-than-normal risk for financial institutions and the deposit insurance funds; therefore, the level of capital institutions need to support this activity should be commensurate with the additional risks incurred. Each subprime lender is responsible for quantifying the amount of capital needed to offset the additional risk in subprime-lending activities, and for *fully documenting* the methodology and analysis supporting the amount specified.

The amount of additional capital necessary will vary according to the volume and type of subprime activities conducted and the adequacy of the institution's risk-management program. An institution's overall capital adequacy will be evaluated on a case-by-case basis through on-site examinations and off-site monitoring procedures, considering, among other factors, the institution's own documented analysis of the capital needed to support subprime lending. Institutions that are determined to have insufficient capital must correct the deficiency within a reasonable time frame or be subject to supervisory action. In light of the higher risks associated with this type of lending, higher minimum-capital requirements may be imposed on institutions engaging in subprime lending.

The sophistication of this analysis should be commensurate with the size, concentration level, and relative risk of the institution's subprime-lending activities and should consider the following elements:

- portfolio-growth rates
- trends in the level and volatility of expected losses
- the level of subprime-loan losses incurred over one or more economic downturns, if such data or analyses are available
- the impact of planned underwriting or marketing changes on the credit characteristics of the portfolio, including the relative levels of risk of default, loss in the event of default, and the level of classified assets
- any deterioration in the average credit quality over time due to adverse selection or retention
- the amount, quality, and liquidity of collateral securing the individual loans
- any asset, income, or funding-source concentrations
- the degree of concentration of subprime credits
- the extent to which current capitalization consists of residual assets or other potentially volatile components
- the degree of legal or reputation risk associated with the subprime business lines pursued
- the amount of capital necessary to support the institution's other risks and activities

Given the higher risk inherent in subprime-lending programs, examiners should reasonably expect, as a starting point, that an institution would hold capital against such portfolios in an amount that is *one and one-half to three times greater* than what is appropriate for non-subprime assets of a similar type. Refinements should depend on the factors analyzed above, with particular emphasis on the trends in the level and volatility of loss rates, and on the amount, quality, and liquidity of collateral securing the loans. Institutions should have capital ratios that are well above the averages for their traditional peer groups or other similarly situated institutions that are not engaged in subprime lending.

Some subprime asset pools warrant increased supervisory scrutiny and monitoring, but not necessarily additional capital. For example, well-secured loans to borrowers who are slightly below what is considered prime quality may entail minimal additional risks compared with prime loans, and they may not require additional capital if adequate controls are in place to address the additional risks. On the other hand, institutions that underwrite higher-risk subprime pools, such as unsecured loans or high loan-to-value second mortgages, may need significantly higher levels of capital, perhaps as high as 100 percent of the loans outstanding, depending on the level and volatility of risk.

Stress Testing

An institution's capital adequacy analysis should include stress testing as a tool for estimating unexpected losses in its subprime-lending pools. Institutions should project the performance of their subprime-loan pools under conservative stress-test scenarios, including an estimation of the portfolio's susceptibility to deteriorating economic, market, and business conditions. Portfolio stress testing should include "shock" testing of basic assumptions, such as delinquency rates, loss rates, and recovery rates on collateral. Stress tests should also consider other potentially adverse scenarios, such as changing attrition or prepayment rates; changing utilization rates for revolving products; changes in credit-score distribution; and changes in the capital-market demand for whole loans or asset-backed securities supported by subprime loans. These are representative examples; actual factors will vary by product, market segment, and the size and complexity of the portfolio relative to the institution's overall operations. Whether stress tests are performed manually, or through automated modeling techniques, it is expected that—

- the process is clearly documented, rational, and easily understood by the institution's board and senior management;
- the inputs are reliable and relate directly to the subject portfolios (for example, baseline loss history or default probabilities should reflect each segment of the institution's portfolio and not just a blend of prime and subprime borrowers);
- assumptions are well documented and conservative; and
- any models are subject to a comprehensive validation process.

The results of the stress-test exercises should be a documented factor in the analysis and determination of capital adequacy for the subprime portfolios.

Institutions that engage in subprime-lending programs without adequate procedures to estimate and document the level of capital necessary to support their activities should be criticized. Where capital is deemed inadequate to support the risk in subprime-lending activities, examiners should consult with their Reserve Bank supervisory official to determine the appropriate course of action. Such actions may include requiring additional capital in accordance with the Federal Reserve's capital adequacy rules, or requiring the institution to submit an acceptable capital plan in accordance with safety-and-soundness guidelines.

Subprime-Lending Examiner Responsibilities

Using the interagency guidance and any supplemental Federal Reserve guidelines, examiners should assess carefully management's ability to administer the higher risk in subprime portfolios. The examiner should judge management's ability to manage the risk involved in the subprime-lending program, in particular, the quality of the risk-management and control processes in place, and more importantly, the extent to which management is adhering to those processes. When examiners determine that risk-management practices are deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement actions or a plan to achieve adequate capitalization. When a primary supervisor determines that an institution's risk-management practices are materially deficient, the primary supervisor may instruct the institution to discontinue its subprime-lending programs.

APPENDIX—QUESTIONS AND ANSWERS FOR EXAMINERS REGARDING THE EXPANDED GUIDANCE FOR SUBPRIME-LENDING PROGRAMS

To assist examiners who review subprime-lending activities, the following questions and answers were developed to provide additional guidance on the expanded interagency guidance that was issued on January 31, 2001.

Applicability of the Guidance

Question 1: Does the guidance apply to all institutions?

No. The guidance will not affect the vast majority of insured institutions engaged in traditional consumer lending. The guidance applies to institutions that *systematically* target the subprime market through *programs* that employ tailored marketing, underwriting standards, and risk selection.

The guidance does not address traditional consumer lending that has historically been the mainstay of community banking. It does not apply to institutions extending credit to subprime borrowers as part of their standard community-lending process, or making loans to subprime borrowers as an occasional exception to a prime-lending program, even if the aggregate of these loans totals more than 25 percent of tier 1 capital. Such institutions continue to be subject to the normal supervisory process.

Institutions engaging in subprime-lending programs generally have knowingly and purposefully focused on the subprime-lending markets through planned business strategies, tailored products, and explicit borrower targeting. In instances where significant exposures to subprime borrowers are identified, examiners should consider the institution's marketing program, loan products, pricing, underwriting standards and practices, and portfolio performance to determine if the institution has a program that warrants the supervision and safeguards outlined in the guidance.

Question 2: Does the guidance apply when an institution offers a product that attracts a disproportionate number of subprime borrowers, but which the institution does not explicitly identify as subprime?

A subprime program commonly features products specifically tailored to borrowers with weakened credit histories. Such products often differ substantially in pricing and terms from products offered to prime borrowers, and usually have separate and distinctly different underwriting standards. An institution offering a product that attracts a disproportionate number of borrowers with weakened credit histories likely has a subprime program whether or not the activity is called a subprime program. The guidance will apply to these programs when the resultant aggregate credit exposure is at least 25 percent of the institution's tier 1 capital.

Institutions with significant programs are expected to have the necessary risk-management and internal-control systems in place to properly identify, measure, monitor, and control the inherent risks in its subprime portfolio. Risk management and controls for these programs typically involve enhanced performance monitoring, intensive collection activities, and other loss-mitigation strategies. If an institution systematically targets the subprime market but does not segregate these loans from its prime portfolio, it is doubtful that the institution has the necessary risk-management and control systems in place to safely engage in the activity.

Subprime Characteristics

Question 3: Why does the Expanded Guidance for Subprime Lending Programs use a credit bureau risk score (FICO) of 660 as a cutoff point for subprime lending?

The guidance does not use credit scores, or any other single risk factor, as a definitive cutoff point for subprime lending. The characteristics listed are not explicit, bright-line definitions. The range of credit characteristics used to describe subprime borrowers is intended to help examiners identify lenders that are engaged in subprime-lending programs. These characteristics describe borrowers with varying, but significantly higher, probabilities of default than prime borrowers. The guidance states that "this list is illustrative rather than exhaustive and is not meant to define specific parameters for all borrowers."

A credit bureau score of 660 (FICO) is used only as an example to illustrate a credit score that generally indicates a higher default probability. The guidance indicates the probability of default, as evidenced by the credit score, will vary by product and collateral. The subprime guidance lists *several* characteristics that denote a higher probability of default. Examiners are directed to use these characteristics as a starting point to expand their review of lending programs targeting subprime borrowers in accordance with risk-focused examination procedures. The severity of risk may vary significantly for the different characteristics listed, as well as for the type and quality of collateral. Examiners should take this into consideration when reviewing the portfolio and determining the adequacy of loan-loss reserves and capital.

The characteristics used in the guidance are well recognized in the investment and lending industries. A number of public debt rating agencies and financial institutions, including the government-sponsored enterprises (GSEs), use similar credit characteristics to differentiate risk among borrowers. Specific examples include the following:

- Fitch defines a subprime borrower as "...one with a credit profile worse than that of a prime A quality borrower, whose credit report would typically reveal no recent mortgage delinquencies and whose credit profile would yield a [FICO] credit score in the range above 680." Fitch's mortgage credit grade matrix lists the following credit-history elements for A-, the highest subprime grade: one 30-day delinquency in the last 12 months on a mortgage debt; one 30-day delinquency in the last 24 months on installment debt, or two 30-day delinquencies in the last 24 months on revolving debt; bankruptcy in past five years; charge-off or judgments exceeding $500 in the past 24 months; and/or a debt-to-income ratio of 45 percent.[1]
- Standard & Poor's subprime-mortgage underwriting guidelines define subprime A-characteristics as two or more 30-day delinquencies on mortgage and consumer credit, one 60-day delinquency on consumer credit, debt-to-income ratio of 45 percent, and no bankruptcy in the past five years. Standard & Poor's also "...considers subprime borrowers to have a FICO credit score of 659 or below."[2]
- Standard & Poor's has classified nonprime B auto securitization pools as having occasional delinquencies and minor charge-offs on revolving debt, static pool net losses of 3.1 percent to 7.5 percent, and FICO credit scores ranging from 620–679.[3]
- Freddie Mac has used the FICO score of 660 or below to designate higher-risk borrowers requiring more comprehensive review. Freddie Mac views a score in the 620–660 range as an indication that the "borrower's willingness to repay debt as agreed is uncertain." FICO scores below 620 are placed in the "cautious-review category," and Freddie Mac considers scores below 620 "as a strong indication that the borrower's credit reputation is not acceptable..."[4]

Capital Guidance

Question 4: If an institution is engaged in subprime lending as described by the guidance, does the 1.5-to-3 times capital described in the guidance automatically apply?

No. The expanded interagency guidance on subprime lending is flexible examination guidance; the capital range does not automatically apply because the guidance is not a capital rule or regulation. Rather, the guidance describes an expectation that subprime lenders hold sufficient loan-loss reserves and capital to offset the additional risks that may exist in subprime activities. The agencies expect institutions to have methodologies and analyses in place to support and document the level of reserves and capital needed

1. Fitch IBCA, Duff & Phelps, "Rating U.S. Residential Subprime Mortgage Securities, March 16, 2001: 2.

2. Standard & Poor's, "U.S. Residential Subprime Mortgage Criteria," Structured Finance, 1999: 12, 169.

3. Standard & Poor's, "Auto Loan Criteria and Market Overview 1998," Structured Finance Ratings Asset-Backed Securities, 6.

4. Freddie Mac, Single-Family Seller/Servicer Guide, chapter 37, section 37.6, "Using FICO Scores in Underwriting," March 7, 2001.

for the additional risks assumed. The higher the risk, the more reserves and capital needed to support the activity. Institutions with lower-risk subprime portfolios may not need additional reserves and capital. In addition, examiners are reminded that subprime lending is only one element in the evaluation of the institution's overall capital adequacy. If the analysis shows that the institution has adequate capital for all its assets and activities, including subprime lending, there is no additional capital requirement arising from the guidance.

Examiners are instructed not to unilaterally require additional reserves and capital based on the guidance. Any determination made by an examiner that an institution's reserves or capital are deficient will be discussed with the institution's management and with each agency's appropriate supervisory office before a final decision is made.

Question 5: Are the regulatory expectations for higher capital levels consistent with capital levels supporting subprime assets outside the insured banking industry?

Yes. The regulatory expectations of higher capital maintenance are consistent with expectations in the capital markets. The 1.5-to-3-times-capital multiple is risk based, e.g., the level of additional capital varies by relative loan quality and is applied only to the subprime portfolio, not the institution's entire asset structure. This is consistent with the financial marketplace's assessment of relative risk in subprime assets outside the banking industry. For example, the amount of credit enhancement required for subprime securitization structures varies according to the level and volatility of perceived credit risk in the underlying assets. In addition, publicly traded subprime-finance companies (that are not currently suffering from adverse ratings) maintain equity-capital-to-managed-asset ratios that are 1.5 to as much as 6 times (depending on loan type and relative quality) those of finance companies that do not specialize in subprime loans.

1. To assess and evaluate the extent of subprime-lending activities; whether management has adequately planned for this activity; and whether management has developed and maintains board-approved policies and procedures, systems, and internal controls that identify, measure, monitor, and control the additional risks.
2. To ascertain whether management has established adequate subprime-lending standards that are commensurate with the risks associated with the subprime-lending program.
3. To conduct portfolio-level reviews and transaction-level testing of the subprime-lending activities, assessing the quality and performance of the subprime-loan portfolios and subprime-lending program, including its profitability, delinquency, and potential and actual loss experience.
4. To assess the adequacy of the allowance for loan and lease losses (ALLL) for the subprime-loan portfolio.

1. Determine whether the subprime-lending activities are consistent with the bank's overall business strategy and risk tolerances, and that the critical business risks have been identified and considered.
2. Assess whether the bank has the financial capacity, including capital adequacy, to conduct the high-risk activity of subprime lending safely, without any undue concentrations of credit.
3. Ascertain if management has committed the necessary resources, that is, technology and skilled personnel, to manage and control the risks associated with the volume and complexity of the subprime-lending program.
4. Determine whether the banking institution's contingency plans are adequate to address the issues of (1) alternative funding sources, (2) back-up purchasers of the securities or the attendant servicing functions, and (3) methods of raising additional capital during an economic downturn or when financial markets become volatile.
5. Determine if management has established adequate lending standards that are appropriate for the size and complexity of the banking organization's operations, and if management is maintaining proper controls over the program. (See "Risk Management" in section 2133.1 for the lending standards that should be included in the subprime-loan program.)
6. Review and evaluate loan-administration and loan-monitoring procedures for subprime loans originated or purchased, including—
   a. collection, repossession, and disclosure procedures;
   b. the management of the number of staff members, the level and effective use of skilled staffing, and advanced technology;
   c. the adequacy of the allowance for loan and lease losses (ALLL); and
   d. the adequacy and accuracy of models used to estimate credit losses or set pricing, making certain that the models account for economic cycles and other unexpected events.
7. Perform a portfolio-level review and conduct some transaction testing. Incorporate examination findings from the portfolio-level and transaction-level testing reviews into the conclusions about overall asset quality, the adequacy of the ALLL and capital, and the adequacy of portfolio risk-management practices.
8. Review securitization transactions for compliance with Statement of Financial Accounting Standards No. 140 (FAS 140) and this guidance, including whether the banking organization has provided any support to maintain the credit quality of loan pools it has securitized.
9. Evaluate the ALLL and regulatory capital allocated to support subprime-lending programs, including whether the total protection for subprime-asset programs and the levels for each component are adequate. Ascertain that a sound risk-management program exists that includes the ability of management to determine and quantify appropriate levels for each component.
10. Analyze the performance of the program, including its profitability, delinquency, and loss experience.
11. Consider management's response to adverse performance trends, such as higher-than-expected prepayments, delinquencies, charge-offs, customer complaints, and expenses.
12. Determine if the banking institution's subprime-lending program effectively manages the credit, market, liquidity, reputational, operational, and legal risks associated with subprime-lending operations.
13. Evaluate the documented analysis of the institution's capital needed to support its subprime-lending activities. Ascertain whether the capital levels are risk sensitive, that is, does allocated capital reflect the level and variability of loss estimates within reasonably conservative parameters? Determine if there is a direct link between the expected loss rates used to determine the required ALLL and the unexpected loss estimates used to determine capital. Document and reference each institution's subprime capital evaluation in the examination comments and conclusions regarding capital adequacy.

14. Classify loans according to the following criteria:
    a. Classify as substandard loans to borrowers that do not have the capacity to service their loans.
    b. Classify as at least substandard subprime loans that are 90 days or more past due based on a reasonable presumption that their past-due status indicates an inadequate capacity or unwillingness to repay.
    c. Consider classifying or criticizing the entire portfolio or segments of the portfolio when the portfolio review or loan sample indicates serious concerns with credit-risk selection practices, underwriting standards, or loan quality.
    d. Classify as substandard high-risk unsecured loan portfolios or secured high loan-to-value loans to borrowers who clearly exhibit inadequate capacity to repay the debt in a reasonable time frame.
15. Report as unsafe and unsound imprudent loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the pledged collateral. Refer such loans to a consumer compliance/fair lending specialist for review.
16. Carefully assess management's ability to administer the higher risk in subprime portfolios. If risk-management practices are deficient, criticize management and reach specific agreements with senior management and the board of directors to initiate corrective action.

An interagency Statement on Subprime Mortgage Lending (the subprime statement) was issued on July 10, 2007 (72 *Fed. Reg.* 37569) by the agencies[1] (same effective date). The subprime statement address issues and questions related to certain adjustable-rate mortgage (ARM) products marketed to subprime borrowers. The statement clarifies how institutions can offer certain ARM products in a safe and sound manner, and in a way that clearly discloses the risks that a borrower may assume from certain ARMs. The statement applies to all banks and their subsidiaries and bank holding companies and their nonbank subsidiaries. See SR-07-12/CA-07-3 and its attachment (the full text of the interagency statement).

The guidance was developed to address emerging risks associated with certain subprime mortgage products and lending practices. The agencies are particularly concerned about the growing use of ARM products[2] that provide low initial payments based on a fixed introductory rate that expires after a short period, and then adjusts to a variable rate plus a margin for the remaining term of the loan. These products could result in payment shock to the borrower. Also, there is concern that these products, typically offered to subprime borrowers, present heightened risks to lenders and borrowers. Often, these products have additional characteristics that increase risk. These include qualifying borrowers based on limited or no documentation of income or imposing substantial prepayment penalties or prepayment penalty periods that extend beyond the initial fixed-interest-rate period.

ARM products originally were extended to customers primarily as a temporary credit accommodation in anticipation of early sale of the property or in expectation of future earnings growth. However, these loans have been offered to subprime borrowers as "credit repair" or "affordability" products. The agencies had concerns that many of these subprime borrowers may not have sufficient financial capacity to service a higher debt load, especially if they were qualified based on a low introductory payment. Also, there was concern that the subprime borrowers may not fully understand the risks and consequences of obtaining these types of ARM products. Borrowers who obtain these loans may face unaffordable monthly payments after the initial rate adjustment, difficulty in paying real estate taxes and insurance that were not escrowed, or expensive refinancing fees, any of which could cause borrowers to default and potentially lose their homes.

1. The Board of Governors of the Federal Reserve System (the Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Office of Thrift Supervision (OTS), and the National Credit Union Administration (NCUA).

2. See footnote 8.

SCOPE OF THE SUBPRIME STATEMENT

The subprime statement emphasizes the need for prudent underwriting standards and clear and balanced consumer information so that institutions and consumers can assess the risks arising from certain ARM products with discounted or low introductory rates. The statement is focused on these types of ARMs and uses the interagency Expanded Guidance for Subprime Lending (the expanded guidance)[3] issued in 2001 to determine subprime borrower characteristics. While the statement is focused on subprime borrowers, the principles in the statement are also relevant to ARM products offered to nonsubprime borrowers.

RISK-MANAGEMENT PRACTICES

The risk-management practices discussed in the subprime statement are generally consistent with existing interagency guidance regarding real estate lending, subprime lending, and nontraditional mortgage products.[4] Like the nontradi-

3. As discussed in the 2001 interagency Expanded Guidance for Subprime Lending Programs, the term "subprime" refers to the characteristics of individual borrowers. Subprime borrowers typically have weakened credit histories that include payment delinquencies and possibly more severe problems, such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories.

4. The 1993 Interagency Guidelines for Real Estate Lending (see SR-93-1 and sections 2090.1–2090.4); the 1999 Interagency Guidance on Subprime Lending (see SR-99-6 and sections 2133.1–2133.3); the 2001 Expanded Guidance for Subprime Lending Programs (see SR-01-4 and sections 2133.1–2133.3); and the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks (see SR-06-15/CA-06-12 and sections 2043.1–2043.4).

tional mortgage guidance issued in 2006, the subprime statement encourages institutions to evaluate the borrower's repayment capacity and ability to repay the loan by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule.[5] Further, the subprime statement emphasizes that an institution's assessment of a borrower's repayment capacity should include an evaluation of the borrower's debt-to-income ratio and states that this assessment should include total monthly housing-related payments (i.e., principal, interest, taxes, and insurance).

WORKOUT ARRANGEMENTS

The subprime statement reiterates the principles in the interagency Statement on Working with Borrowers (April 2007) in which the agencies encouraged institutions to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Both documents indicate that prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower. The Federal Reserve will not criticize institutions that pursue reasonable workout arrangements with borrowers.

SUPERVISORY REVIEW

Federal Reserve examiners are expected to carefully review an institution's risk management, consumer-disclosure practices, and consumer compliance, concerns which are contained in the subprime statement as a part of ongoing examination activities. Examiners will take action against institutions that exhibit predatory lending practices, violate consumer protection or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

5. The nontraditional mortgage (NTM) guidance covers mortgage products that allow borrowers to defer payment of principal and sometimes interest, including interest-only mortgages when a borrower pays no loan principal for the first few years of the loan and payment-option ARMs when a borrower has flexible payment options with the potential for negative amortization. Because certain ARM products offered to subprime borrowers are fully amortizing, the NTM guidance does not cover such products.

STATEMENT ON SUBPRIME MORTGAGE LENDING

The Statement on Subprime Mortgage Lending (the subprime statement) was developed by the agencies to address emerging issues and questions relating to certain subprime[6] mortgage lending practices. The agencies stated their concern that borrowers may not fully understand the risks and consequences of obtaining products that can cause payment shock.[7] In particular, they have concerns with certain adjustable-rate mortgage (ARM) products typically offered to subprime borrowers that have one or more of the following characteristics:

- low initial payments based on a fixed introductory rate that expires after a short period and then adjusts to a variable index rate plus a margin for the remaining term of the loan;[8]
- very high or no limits on how much the payment amount or the interest rate may increase ("payment or rate caps") on reset dates;
- limited or no documentation of borrowers' income;
- product features likely to result in frequent refinancing to maintain an affordable monthly payment; and/or
- substantial prepayment penalties and/or prepayment penalties that extend beyond the initial fixed-interest-rate period.

Products with one or more of these features present substantial risks to both consumers and lenders. These risks are increased if borrowers are not adequately informed of the product features and risks, including their responsibility for paying real estate taxes and insurance, which may be separate from their monthly mortgage payments. The consequences to borrowers could

6. The term "subprime" is described in the 2001 Expanded Guidance for Subprime Lending Programs. (See SR-01-4 and sections 2133.1–2133.3)

7. *Payment shock* refers to a significant increase in the amount of the monthly payment that generally occurs as the interest rate adjusts to a fully indexed basis. Products with a wide spread between the initial interest rate and the fully indexed rate that do not have payment caps or periodic interest rate caps, or that contain very high caps, can produce significant payment shock.

8. For example, ARMs known as "2/28" loans feature a fixed rate for two years and then adjust to a variable rate for the remaining 28 years. The spread between the initial fixed interest rate and the fully indexed interest rate in effect at loan origination typically ranges from 300 to 600 basis points.

include being unable to afford the monthly payments after the initial rate adjustment because of payment shock; experiencing difficulty in paying real estate taxes and insurance that were not escrowed; incurring expensive refinancing fees, frequently due to closing costs and prepayment penalties, especially if the prepayment penalty period extends beyond the rate adjustment date; and losing their homes. Consequences to lenders may include unwarranted levels of credit, legal, compliance, reputation, and liquidity risks due to the elevated risks inherent in these products.

Many of these concerns are addressed in existing interagency guidance. The most prominent are the 1993 Interagency Guidelines for Real Estate Lending (real estate guidelines) (see SR-93-1 and sections 2090.1–2090.4), the 1999 Interagency Guidance on Subprime Lending (see SR-99-6 and sections 2133.1–2133.3)) and the 2001 Expanded Guidance for Subprime Lending Programs (expanded subprime guidance) (see SR-01-4 and sections 2133.1–2133.3).

While the 2006 Interagency Guidance on Nontraditional Mortgage Product Risks (NTM guidance)[9] may not explicitly pertain to products with the characteristics addressed in this statement, it outlines prudent underwriting and consumer protection principles that institutions also should consider with regard to subprime mortgage lending. This statement reiterates many of the principles addressed in existing guidance relating to prudent risk-management practices and consumer protection laws.[10]

Risk-Management Practices

Predatory Lending Considerations

Subprime lending is not synonymous with predatory lending, and loans with the features described above are not necessarily predatory in nature. However, institutions should ensure that they do not engage in the types of predatory lending practices discussed in the expanded subprime guidance. Typically, predatory lending involves at least one of the following elements:

- making loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on the borrower's ability to repay the mortgage according to its terms;
- inducing a borrower to repeatedly refinance a loan in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
- engaging in fraud or deception to conceal the true nature of the mortgage loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.

Institutions offering mortgage loans such as these face an elevated risk that their conduct will violate section 5 of the Federal Trade Commission Act (FTC Act), which prohibits unfair or deceptive acts or practices.[11]

Underwriting Standards

Institutions should refer to the real estate guidelines, which provide underwriting standards for all real estate loans.[12] The real estate guidelines state that prudently underwritten real estate loans should reflect all relevant credit factors, including the capacity of the borrower to adequately service the debt. The 2006 NTM guidance details similar criteria for qualifying borrowers for products that may result in payment shock.

Prudent qualifying standards recognize the potential effect of payment shock in evaluating a borrower's ability to service debt. An institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by its final maturity at the fully indexed rate,[13] assuming a fully

9. See SR-06-1, sections 2043.1–2043.4, and 71 *Fed. Reg.* 58609 (October 4, 2006).

10. As with the NTM guidance, this statement applies to all banks and their subsidiaries as well as to bank holding companies and their nonbank subsidiaries.

11. The Board, the OCC, the OTS, and the FDIC enforce this provision under section 8 of the Federal Deposit Insurance Act. The Board, the OCC, and the FDIC also have issued supervisory guidance to the institutions under their respective jurisdictions concerning unfair or deceptive acts or practices. See OCC Advisory Letter 2002-3, Guidance on Unfair or Deceptive Acts or Practices, March 22, 2002, and 12 CFR 30, appendix C; Joint Board and FDIC Guidance on Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004.

12. Refer to 12 CFR 208, subpart C.

13. The fully indexed rate equals the index rate prevailing at origination plus the margin to be added to it after the expiration of an introductory interest rate. For example, assume that a loan with an initial fixed rate of 7 percent will reset to the six-month London Interbank Offered Rate (LIBOR) plus a margin of 6 percent. If the six-month LIBOR rate

amortizing repayment schedule.[14]

One widely accepted approach in the mortgage industry is to quantify a borrower's repayment capacity by a debt-to-income (DTI) ratio. An institution's DTI analysis should include, among other things, an assessment of a borrower's total monthly housing-related payments (e.g., principal, interest, taxes, and insurance, or what is commonly known as PITI) as a percentage of gross monthly income.

This assessment is particularly important if the institution relies upon reduced documentation or allows other forms of risk layering. Risk-layering features in a subprime mortgage loan may significantly increase the risks to both the institution and the borrower. Therefore, an institution should have clear policies governing the use of risk-layering features, such as reduced-documentation loans or simultaneous second-lien mortgages. When risk-layering features are combined with a mortgage loan, an institution should demonstrate the existence of effective mitigating factors that support the underwriting decision and the borrower's repayment capacity.

Recognizing that loans to subprime borrowers present elevated credit risk, institutions should verify and document the borrower's income (both source and amount), assets, and liabilities. Stated-income and reduced-documentation loans to subprime borrowers should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. Reliance on such factors also should be documented. Typically, mitigating factors arise when a borrower with favorable payment performance seeks to refinance an existing mortgage with a new loan of a similar size and with similar terms, and the borrower's financial condition has not deteriorated. Other mitigating factors might include situations where a borrower has substantial liquid reserves or assets that demonstrate repayment capacity and can be verified and documented by the lender. However, a higher interest rate is not considered an acceptable mitigating factor.

equals 5.5 percent, lenders should qualify the borrower at 11.5 percent (5.5 percent + 6 percent), regardless of any interest rate caps that limit how quickly the fully indexed rate may be reached.

14. The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a "2/28" loan would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

Workout Arrangements

As discussed in the April 2007 Interagency Statement on Working with Borrowers (see SR-07-6/CA-07-1), financial institutions are encouraged to work constructively with residential borrowers who are in default or whose default is reasonably foreseeable. Prudent workout arrangements that are consistent with safe and sound lending practices are generally in the long-term best interest of both the financial institution and the borrower.

Financial institutions should follow prudent underwriting practices in determining whether to consider a loan modification or a workout arrangement.[15] Such arrangements can vary widely based on the borrower's financial capacity. For example, an institution might consider modifying loan terms, including converting loans with variable rates into fixed-rate products to provide financially stressed borrowers with predictable payment requirements.

The agencies will not criticize financial institutions that pursue reasonable workout arrangements with borrowers. Further, existing supervisory guidance and applicable accounting standards do not require institutions to immediately foreclose on the collateral underlying a loan when the borrower exhibits repayment difficulties. Institutions should identify and report credit risk, maintain an adequate allowance for loan losses, and recognize credit losses in a timely manner.

Consumer Protection Principles

Fundamental consumer protection principles relevant to the underwriting and marketing of mortgage loans include—

- approving loans based on the borrower's ability to repay the loan according to its terms; and
- providing information that enables consumers to understand material terms, costs, and risks of loan products at a time that will help the consumer select a product.

Communications with consumers, including

15. Institutions may need to account for workout arrangements as troubled-debt restructurings and should follow generally accepted accounting principles in accounting for these transactions.

advertisements, oral statements, and promotional materials, should provide clear and balanced information about the relative benefits and risks of the products. This information should be provided in a timely manner to assist consumers in the product-selection process, not just upon submission of an application or at consummation of the loan. Institutions should not use such communications to steer consumers to these products to the exclusion of other products offered by the institution for which the consumer may qualify.

Information provided to consumers should clearly explain the risk of payment shock and the ramifications of prepayment penalties, balloon payments, and the lack of escrow for taxes and insurance, as necessary. The applicability of prepayment penalties should not exceed the initial reset period. In general, borrowers should be provided a reasonable period of time (typically at least 60 days prior to the reset date) to refinance without penalty.

Similarly, if borrowers do not understand that their monthly mortgage payments do not include taxes and insurance, and they have not budgeted for these essential homeownership expenses, they may be faced with the need for significant additional funds on short notice.[16] Therefore, mortgage-product descriptions and advertisements should provide clear, detailed information about the costs, terms, features, and risks of the loan to the borrower. Consumers should be informed of—

- *payment shock*: potential payment increases, including how the new payment will be calculated when the introductory fixed rate expires;[17]
- *prepayment penalties*: the existence of any prepayment penalty, how it will be calculated, and when it may be imposed;
- *balloon payments*: the existence of any balloon payment;
- *cost of reduced-documentation loans*: whether there is a pricing premium attached to a reduced-documentation or stated-income loan program; and
- *responsibility for taxes and insurance*: the requirement to make payments for real estate taxes and insurance in addition to their loan payments, if not escrowed, and the fact that taxes and insurance costs can be substantial.

Control Systems

Institutions should develop strong control systems to monitor whether actual practices are consistent with their policies and procedures. Systems should address compliance and consumer information concerns, as well as safety and soundness, and encompass both institution personnel and applicable third parties, such as mortgage brokers or correspondents.

Important controls include establishing appropriate criteria for hiring and training loan personnel, entering into and maintaining relationships with third parties, and conducting initial and ongoing due diligence on third parties. Institutions also should design compensation programs that avoid providing incentives for originations inconsistent with sound underwriting and consumer protection principles, and that do not result in the steering of consumers to these products to the exclusion of other products for which the consumer may qualify.

Institutions should have procedures and systems in place to monitor compliance with applicable laws and regulations, third-party agreements, and internal policies. An institution's controls also should include appropriate corrective actions in the event of failure to comply with applicable laws, regulations, third-party agreements, or internal policies. In addition, institutions should initiate procedures to review consumer complaints to identify potential compliance problems or other negative trends.

Supervisory Review

The agencies will continue to carefully review risk-management and consumer compliance processes, policies, and procedures. The agen-

16. Institutions generally can address these concerns most directly by requiring borrowers to escrow funds for real estate taxes and insurance.

17. To illustrate: a borrower earning $42,000 per year obtains a $200,000 "2/28" mortgage loan. The loan's two-year introductory fixed interest rate of 7 percent requires a principal and interest payment of $1,331. Escrowing $200 per month for taxes and insurance results in a total monthly payment of $1,531 ($1,331 + $200), representing a 44 percent DTI ratio. A fully indexed interest rate of 11.5 percent (based on a six-month LIBOR index rate of 5.5 percent plus a 6 percent margin) would cause the borrower's principal and interest payment to increase to $1,956. The adjusted total monthly payment of $2,156 ($1,956 + $200 for taxes and insurance) represents a 41 percent increase in the payment amount and results in a 62 percent DTI ratio.

cies will take action against institutions that exhibit predatory lending practices, violate consumer protection laws or fair lending laws, engage in unfair or deceptive acts or practices, or otherwise engage in unsafe or unsound lending practices.

The Federal Reserve and the other federal banking and thrift regulatory agencies (the agencies)[1] issued the Interagency Guidance on Nontraditional Mortgage Product Risks on September 29, 2006. The guidance addresses both risk-management and consumer disclosure practices that institutions[2] should employ to effectively manage the risks associated with closed-end residential mortgage products that allow borrowers to defer repayment of principal and, sometimes, interest (referred to as nontraditional mortgage loans). (See SR-06-15.)

Residential mortgage lending has traditionally been a conservatively managed business with low delinquencies and losses and reasonably stable underwriting standards. However, during the past few years consumer demand has been growing, particularly in high-priced real estate markets, for nontraditional mortgage loans. These mortgage products include such products as ''interest-only'' mortgages, where a borrower pays no loan principal for the first few years of the loan, and ''payment-option'' adjustable-rate mortgages (ARMs), where a borrower has flexible payment options with the potential for negative amortization.[3]

While some institutions have offered nontraditional mortgages for many years with appropriate risk management and sound portfolio performance, the market for these products and the number of institutions offering them has expanded rapidly. Nontraditional mortgage loan products are now offered by more lenders to a wider spectrum of borrowers; these borrowers may not otherwise qualify for more traditional mortgage loans and may not fully understand the risks associated with nontraditional mortgage loans.

Many of these nontraditional mortgage loans are underwritten with less stringent income and asset verification requirements (reduced documentation) and are increasingly combined with simultaneous second-lien loans.[4] Such risk layering, combined with the broader marketing of nontraditional mortgage loans, exposes financial institutions to increased risk relative to traditional mortgage loans.

Given the potential for heightened risk levels, management should carefully consider and appropriately mitigate exposures created by these loans. To manage the risks associated with nontraditional mortgage loans, management should—

- ensure that loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
- ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice; and
- recognize that many nontraditional mortgage loans, particularly when they have risk-layering features, are untested in a stressed environment. As evidenced by experienced institutions, these products warrant strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio. The Federal Reserve expects institutions to effectively assess and manage the risks associated with nontraditional mortgage loan products.[5]

Institutions should use the guidance to ensure that risk-management practices adequately address these risks. Risk-management processes, policies, and procedures in this area will be carefully scrutinized. Institutions that do not adequately manage these risks will be asked to take remedial action.

This guidance focuses on the higher risk elements of certain nontraditional mortgage products, not the product type itself. Institutions with sound underwriting, adequate risk management,

1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

2. The term *institution(s)* is used in the interagency guidance. As used in this section, *institutions* applies to Federal Reserve-supervised state member banks and their subsidiaries, and bank holding companies and their nonbank subsidiaries.

3. Interest-only and payment-option ARMs are variations of conventional ARMs, hybrid ARMs, and fixed-rate products. Refer to the appendix for additional information on interest-only and payment-option ARM loans. This guidance does not apply to reverse mortgages; home equity lines of credit (HELOCs), other than as discussed in the Simultaneous Second-Lien Loans section; or fully amortizing residential mortgage loan products.

4. Refer to the appendix for additional information on reduced documentation and simultaneous second-lien loans.

5. Refer to the Interagency Guidelines Establishing Standards for Safety and Soundness in 12 CFR 208, appendix D-1.

and acceptable portfolio performance will not be subject to criticism merely for offering such products.

NONTRADITIONAL MORTGAGE LOAN TERMS AND UNDERWRITING STANDARDS

When an institution offers nontraditional mortgage loan products, underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins. Underwriting standards should also comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.[6]

Central to prudent lending is the internal discipline to maintain sound loan terms and underwriting standards despite competitive pressures. Institutions are strongly cautioned against ceding underwriting standards to third parties that have different business objectives, risk tolerances, and core competencies. Loan terms should be based on a disciplined analysis of potential exposures and compensating factors to ensure that risk levels remain manageable.

Qualifying Borrowers for Nontraditional Loans

Payments on nontraditional loans can increase significantly when the loans begin to amortize. Commonly referred to as *payment shock*, this increase is of particular concern for payment-option ARMs where the borrower makes minimum payments that may result in negative amortization. Some institutions manage the potential for excessive negative amortization and payment shock by structuring the initial terms to limit the spread between the introductory interest rate and the fully indexed rate. Nevertheless, an institution's qualifying standards should recognize the potential impact of payment shock, especially for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores. Recognizing that an institution's underwriting criteria are based on multiple factors, an institution should consider these factors jointly in the qualification process and potentially it may develop a range of reasonable tolerances for each factor. However, the criteria should be based upon prudent and appropriate underwriting standards, considering both the borrower's characteristics and the product's attributes.

For all nontraditional mortgage loan products, an institution's analysis of a borrower's repayment capacity should include an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate,[7] assuming a fully amortizing repayment schedule.[8] In addition, for products that permit negative amortization, the repayment analysis should be based upon the initial loan amount plus any balance increase that may accrue from the negative amortization provision.[9]

Furthermore, the analysis of repayment capacity should avoid overreliance on credit scores as a substitute for income verification in the underwriting process. The higher a loan's credit risk, either from loan features or borrower characteristics, the more important it is to verify the

6. Refer to 12 CFR 208.51 subpart E and appendix C and 12 CFR 225 subpart G.

7. The fully indexed rate equals the index rate prevailing at origination plus the margin that will apply after the expiration of an introductory interest rate. The index rate is a published interest rate to which the interest rate on an ARM is tied. Some commonly used indices include the 1-Year Constant Maturity Treasury Rate (CMT), the 6-Month London Interbank Offered Rate (LIBOR), the 11th District Cost of Funds (COFI), and the Moving Treasury Average (MTA), a 12-month moving average of the monthly average yields of U.S. Treasury securities adjusted to a constant maturity of one year. The margin is the number of percentage points a lender adds to the index value to calculate the ARM interest rate at each adjustment period. In different interest-rate scenarios, the fully indexed rate for an ARM loan based on a lagging index (for example, the MTA rate) may be significantly different from the rate on a comparable 30-year fixed-rate product. In these cases, a credible market rate should be used to qualify the borrower and determine repayment capacity.

8. The fully amortizing payment schedule should be based on the term of the loan. For example, the amortizing payment for a loan with a 5-year interest-only period and a 30-year term would be calculated based on a 30-year amortization schedule. For balloon mortgages that contain a borrower option for an extended amortization period, the fully amortizing payment schedule can be based on the full term the borrower may choose.

9. The balance that may accrue from the negative amortization provision does not necessarily equate to the full negative amortization cap for a particular loan. The spread between the introductory or "teaser" rate and the accrual rate will determine whether a loan balance has the potential to reach the negative amortization cap before the end of the initial payment-option period (usually five years). For example, a loan with a 115 percent negative amortization cap but only a small spread between the introductory rate and the accrual rate may reach a 109 percent maximum loan balance before the end of the initial payment-option period, even if only minimum payments are made. The borrower could be qualified based on this lower maximum loan balance.

borrower's income, assets, and outstanding liabilities.

Collateral-Dependent Loans

Institutions should avoid the use of loan terms and underwriting practices that may heighten the need for a borrower to rely on the sale or refinancing of the property once amortization begins. Loans to individuals who do not demonstrate the capacity to repay, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.[10] Institutions that originate collateral-dependent mortgage loans may be subject to criticism, corrective action, and higher capital requirements.

Risk Layering

Institutions that originate or purchase mortgage loans that combine nontraditional features, such as interest-only loans with reduced documentation or a simultaneous second-lien loan, face increased risk. When features are layered, an institution should demonstrate that mitigating factors support the underwriting decision and the borrower's repayment capacity. Mitigating factors could include higher credit scores, lower LTV and DTI ratios, significant liquid assets, mortgage insurance, and other credit enhancements. While higher pricing is often used to address elevated risk levels, it does not replace the need for sound underwriting.

Reduced Documentation

Institutions increasingly rely on reduced documentation, particularly unverified income, to qualify borrowers for nontraditional mortgage loans. Because these practices essentially substitute assumptions and unverified information for analysis of a borrower's repayment capacity and general creditworthiness, they should be used with caution. As the level of credit risk increases, the Federal Reserve expects an institution to more diligently verify and document a borrower's income and debt-reduction capacity.

Clear policies should govern the use of reduced documentation. For example, stated income should be accepted only if there are mitigating factors that clearly minimize the need for direct verification of repayment capacity. For many borrowers, institutions generally should be able to readily document income using recent W-2 statements, pay stubs, or tax returns.

Simultaneous Second-Lien Loans

Simultaneous second-lien loans reduce owner equity and increase credit risk. Historically, as combined loan-to-value ratios rise, so do defaults. A delinquent borrower with minimal or no equity in a property may have little incentive to work with a lender to bring the loan current and avoid foreclosure. In addition, second-lien HELOCs typically increase borrower exposure to increasing interest rates and monthly payment burdens. Loans with minimal or no owner equity generally should not have a payment structure that allows for delayed or negative amortization without other significant risk-mitigating factors.

Introductory Interest Rates

As a marketing tool for payment-option ARM products, many institutions offer introductory interest rates set well below the fully indexed rate. When developing nontraditional mortgage product terms, an institution should consider the spread between the introductory rate and the fully indexed rate. Since initial and subsequent monthly payments are based on these low introductory rates, a wide initial spread means that borrowers are more likely to experience negative amortization, severe payment shock, and an earlier-than-scheduled recasting of monthly payments. Institutions should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates.

Lending to Subprime Borrowers

Mortgage programs that target subprime borrowers through tailored marketing, underwriting standards, and risk selection should follow the applicable interagency guidance on subprime

10. A loan will not be determined to be "collateral-dependent" solely through the use of reduced documentation.

lending.[11] Among other things, the subprime guidance discusses circumstances under which subprime lending can become predatory or abusive. Institutions designing nontraditional mortgage loans for subprime borrowers should pay particular attention to this guidance. They should also recognize that risk-layering features in loans to subprime borrowers may significantly increase risks for the institution and the borrower.

Non-Owner-Occupied Investor Loans

Borrowers financing non-owner-occupied investment properties should qualify for loans based on their ability to service the debt over the life of the loan. Loan terms should reflect an appropriate combined LTV ratio that considers the potential for negative amortization and maintains sufficient borrower equity over the life of the loan. Further, underwriting standards should require evidence that the borrower has sufficient cash reserves to service the loan, considering the possibility of extended periods of property vacancy and the variability of debt service requirements associated with nontraditional mortgage loan products.

PORTFOLIO AND RISK-MANAGEMENT PRACTICES

Institutions should ensure that risk-management practices keep pace with the growth and changing risk profile of their nontraditional mortgage loan portfolios and changes in the market. Active portfolio management is especially important for institutions that project or have already experienced significant growth or concentration levels. Institutions that originate or invest in nontraditional mortgage loans should adopt more robust risk-management practices and manage these exposures in a thoughtful, systematic manner. To meet these expectations, institutions should—

- develop written policies that specify acceptable product attributes, production and portfolio limits, sales and securitization practices, and risk-management expectations;
- design enhanced performance measures and management reporting that provide early warning for increasing risk;
- establish appropriate ALLL levels that consider the credit quality of the portfolio and conditions that affect collectibility; and
- maintain capital at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility. Institutions should hold capital commensurate with the risk characteristics of their nontraditional mortgage loan portfolios.

Nontraditional Mortgage Loan Policies

An institution's policies for nontraditional mortgage lending activity should set acceptable levels of risk through its operating practices, accounting procedures, and policy exception tolerances. Policies should reflect appropriate limits on risk layering and should include risk-management tools for risk-mitigation purposes. Further, an institution should set growth and volume limits by loan type, with special attention for products and product combinations in need of heightened attention due to easing terms or rapid growth.

Concentrations in Nontraditional Mortgage Products

Institutions with concentrations in nontraditional mortgage products should have well-developed monitoring systems and risk-management practices. Monitoring systems should keep track of concentrations in key portfolio segments such as loan types, third-party originations, geographic area, and property occupancy status. Concentrations also should be monitored by key portfolio characteristics such as non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers below established thresholds, and (5) risk-layered features. Further, institutions should consider the effect of employee incentive programs that could produce higher concentrations of nontraditional mortgage loans. Concentrations

11. See SR-99-6, Subprime Lending and its attachment, Interagency Guidance on Subprime Lending, March 1, 1999, and SR-01-4, Subprime Lending and its attachment, interagency Expanded Guidance for Subprime Lending Programs, January 31, 2001.

that are not effectively managed will be subject to elevated supervisory attention and potential examiner criticism to ensure timely remedial action.

Controls

An institution's quality control, compliance, and audit procedures should focus on mortgage lending activities posing high risk. Controls to monitor compliance with underwriting standards and exceptions to those standards are especially important for nontraditional loan products. The quality control function should regularly review a sample of nontraditional mortgage loans from all origination channels and a representative sample of underwriters to confirm that policies are being followed. When control systems or operating practices are found deficient, business-line managers should be held accountable for correcting deficiencies in a timely manner.

Since many nontraditional mortgage loans permit a borrower to defer principal and, in some cases, interest payments for extended periods, institutions should have strong controls over accruals, customer service, and collections. Policy exceptions made by servicing and collections personnel should be carefully monitored to confirm that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk. Customer service and collections personnel should receive product-specific training on the features and potential customer issues with these products.

Third-Party Originations

Institutions often use third parties, such as mortgage brokers or correspondents, to originate nontraditional mortgage loans. Institutions should have strong systems and controls in place for establishing and maintaining relationships with third parties, including procedures for performing due diligence. Oversight of third parties should involve monitoring the quality of originations so that they reflect the institution's lending standards and compliance with applicable laws and regulations.

Monitoring procedures should track the quality of loans by both origination source and key borrower characteristics. This will help institutions identify problems such as early payment defaults, incomplete documentation, and fraud. If problems involving appraisals, loan documentation, credit, or consumer complaints are discovered, the institution should take immediate action. Remedial action could include more thorough application reviews, more frequent re-underwriting, and even termination of the third-party relationship.

Risk Management of Secondary-Market Activity

The sophistication of an institution's secondary-market risk-management practices should be commensurate with the nature and volume of activity. Institutions with significant secondary-market activities should have comprehensive, formal strategies for managing risks.[12] Contingency planning should include how the institution will respond to reduced demand in the secondary market.

While third-party loan sales can transfer a portion of the credit risk, an institution remains exposed to reputation risk when credit losses on sold mortgage loans or securitization transactions exceed expectations. As a result, an institution may determine that it is necessary to repurchase defaulted mortgages to protect its reputation and maintain access to the markets. In the Federal Reserve's view, the repurchase of mortgage loans beyond the selling institution's contractual obligation is implicit recourse. Under the risk-based capital rules, a repurchasing institution would be required to maintain risk-based capital against the entire pool or securitization.[13] Institutions should familiarize themselves with these guidelines before deciding to support mortgage loan pools or buying back loans in default.

Management Information and Reporting

Reporting systems should allow management to detect changes in the risk profile of its nontraditional mortgage loan portfolio. The structure

12. Refer to SR-02-16, dated May 23, 2002, Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations and its attachment.

13. Refer to 12 CFR 208 and 225, appendix A, III.B.3.

and content should allow the isolation of key loan products, risk-layering loan features, and borrower characteristics. Reporting should also allow management to recognize deteriorating performance in any of these areas before it has progressed too far. At a minimum, information should be available by (1) loan type (for example, interest-only mortgage loans and payment-option ARMs); (2) risk-layering features (for example, payment-option ARMs with stated income and interest-only mortgage loans with simultaneous second-lien mortgages); (3) underwriting characteristics (for example, LTV, DTI, and credit score); and (4) borrower performance (for example, payment patterns, delinquencies, interest accruals, and negative amortization).

Portfolio volume and performance should be tracked against expectations, internal lending standards, and policy limits. Volume and performance expectations should be established at the subportfolio and aggregate portfolio levels. Variance analyses should be performed regularly to identify exceptions to policies and prescribed thresholds. Qualitative analysis should occur when actual performance deviates from established policies and thresholds. Variance analysis is critical to the monitoring of a portfolio's risk characteristics and should be an integral part of establishing and adjusting risk-tolerance levels.

Stress Testing

Based on the size and complexity of their lending operations, institutions should perform sensitivity analysis on key portfolio segments to identify and quantify events that may increase risks in a segment or the entire portfolio. The scope of the analysis should generally include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the institution's immediate control. Stress tests typically assume rapid deterioration in one or more factors and attempt to estimate the potential influence on default rates and loss severity. Stress testing should aid an institution in identifying, monitoring, and managing risk, as well as developing appropriate and cost-effective loss-mitigation strategies. The stress testing results should provide direct feedback in determining underwriting standards, product terms, portfolio concentration limits, and capital levels.

Capital and the Allowance for Loan and Lease Losses

Institutions should establish an appropriate ALLL for the estimated credit losses inherent in their nontraditional mortgage loan portfolios. They should also consider the higher risk of loss posed by layered risks when establishing their ALLL.

Moreover, institutions should recognize that their limited performance history with these products, particularly in a stressed environment, increases performance uncertainty. Capital levels should be commensurate with the risk characteristics of the nontraditional mortgage loan portfolios. Lax underwriting standards or poor portfolio performance may warrant higher capital levels.

When establishing an appropriate ALLL and considering the adequacy of capital, institutions should segment their nontraditional mortgage loan portfolios into pools with similar credit-risk characteristics. The basic segments typically include collateral and loan characteristics, geographic concentrations, and borrower qualifying attributes. Segments could also differentiate loans by payment and portfolio characteristics, such as loans on which borrowers usually make only minimum payments, mortgages with existing balances above original balances, and mortgages subject to sizable payment shock. The objective is to identify credit quality indicators that affect collectibility for ALLL measurement purposes. In addition, understanding characteristics that influence expected performance also provides meaningful information about future loss exposure that would aid in determining adequate capital levels.

Institutions with material mortgage banking activities and mortgage servicing assets should apply sound practices in valuing the mortgage servicing rights for nontraditional mortgages. The valuation process should follow generally accepted accounting principles and use reasonable and supportable assumptions.[14]

14. See SR-03-4, dated February 25, 2003, Interagency Advisory on Mortgage Banking and its attachment, which has the same title.

CONSUMER PROTECTION ISSUES

While nontraditional mortgage loans provide flexibility for consumers, the Federal Reserve is concerned that consumers may enter into these transactions without fully understanding the product terms. Nontraditional mortgage products have been advertised and promoted based on their affordability in the near term; that is, their lower initial monthly payments compared with traditional types of mortgages. In addition to apprising consumers of the benefits of nontraditional mortgage products, institutions should take appropriate steps to alert consumers to the risks of these products, including the likelihood of increased future payment obligations. This information should be provided in a timely manner—before disclosures may be required under the Truth in Lending Act or other laws—to assist the consumer in the product selection process.

Concerns and Objectives

More than traditional ARMs, mortgage products such as payment-option ARMs and interest-only mortgages can carry a significant risk of payment shock and negative amortization, neither of which may be fully understood by consumers. For example, consumer payment obligations may increase substantially at the end of an interest-only period or upon the "recast" of a payment-option ARM. The magnitude of these payment increases may be affected by factors such as the expiration of promotional interest rates, increases in the interest-rate index, and negative amortization. Negative amortization also results in lower levels of home equity as compared with a traditional amortizing mortgage product. When borrowers go to sell or refinance the property, they may find that negative amortization has substantially reduced or eliminated their equity in the property—even when the property has appreciated. The concern that consumers may not fully understand these products is exacerbated by marketing and promotional practices that emphasize potential benefits without also providing clear and balanced information about material risks.

In light of these considerations, communications with consumers, including advertisements, oral statements, promotional materials, and monthly statements, should provide clear and balanced information about the relative benefits and risks of these products, including the risks of payment shock and of negative amortization. Clear, balanced, and timely communication to consumers of the risks of these products will provide consumers with useful information at crucial decision-making points, such as when they are shopping for loans or deciding which monthly payment amount to make. Such communication should help minimize potential consumer confusion and complaints, foster good customer relations, and reduce legal and other risks to the institution.

Legal Risks

Institutions that offer nontraditional mortgage products must ensure that they do so in a manner that complies with all applicable laws and regulations. With respect to the disclosures and other information provided to consumers, applicable laws and regulations include the following:

- Truth in Lending Act (TILA) and its implementing regulation, Regulation Z
- Section 5 of the Federal Trade Commission Act (FTC Act)

TILA and Regulation Z contain rules governing disclosures that institutions must provide for closed-end mortgages (1) in advertisements, (2) with an application,[15] (3) before loan consummation, and (4) when interest rates change. Section 5 of the FTC Act prohibits unfair or deceptive acts or practices.[16]

Other federal laws, including the fair-lending laws and the Real Estate Settlement Procedures Act (RESPA), also apply to these transactions. Moreover, the Federal Reserve notes that the sale or securitization of a loan may not affect an institution's potential liability for violations of TILA, RESPA, the FTC Act, or other laws in connection with its origination of the loan. State laws, including laws regarding unfair or deceptive acts or practices, also may apply.

15. These program disclosures apply to ARM products and must be provided at the time an application is provided or before the consumer pays a nonrefundable fee, whichever is earlier.

16. The Board of Governors enforces this provision under the FTC Act and section 8 of the Federal Deposit Insurance Act. See the joint Board and FDIC guidance titled Unfair or Deceptive Acts or Practices by State-Chartered Banks, March 11, 2004.

Recommended Practices

Recommended practices for addressing the risks raised by nontraditional mortgage products include the following:[17]

Communications with Consumers

When promoting or describing nontraditional mortgage products, institutions should provide consumers with information that is designed to help them make informed decisions when selecting and using these products. Meeting this objective requires appropriate attention to the timing, content, and clarity of information presented to consumers. Thus, institutions should provide consumers with information at a time that will help consumers select products and choose among payment options. For example, institutions should offer clear and balanced product descriptions when (1) a consumer is shopping for a mortgages (such as when the consumer makes an inquiry to the institution about a mortgage product and receives information about nontraditional mortgage products) or (2) when marketing relating to nontraditional mortgage products is provided by the institution to the consumer. Clear and balanced information should not be offered by the institution only upon the submission of an application or at consummation.[18] The provision of such information would serve as an important supplement to the disclosures currently required under TILA and Regulation Z as well as other laws.[19]

17. Institutions should review the recommendations relating to mortgage lending practices set forth in other supervisory guidance from their respective primary regulators, as applicable, including guidance on abusive lending practices.

18. Institutions also should strive to (1) focus on information important to consumer decision making; (2) highlight key information to make it more prominent; (3) employ a user-friendly and readily navigable format for presenting the information; and (4) use plain language, with concrete and realistic examples. Comparative tables and information describing key features of available loan products, including reduced documentation programs, also may be useful for consumers who are considering the nontraditional mortgage products and other loan features described in this guidance.

19. Institutions may not be able to incorporate all of the practices recommended in this guidance when advertising nontraditional mortgages through certain forms of media, such as radio, television, or billboards. Nevertheless, institutions should provide clear and balanced information about the risks of these products in all forms of advertising.

Promotional Materials and Product Descriptions

To assist other consumers in their product selection decisions, promotional materials and other product descriptions should provide information about the costs, terms, features, and risks of nontraditional mortgages (including information about the matters discussed below).

Payment Shock. Institutions should apprise consumers of potential increases in payment obligations for these products, including circumstances in which interest rates or negative amortization reach a contractual limit. For example, product descriptions could state the maximum monthly payment a consumer would be required to pay under a hypothetical loan example once amortizing payments are required and the interest rate and negative amortization caps have been reached.[20] Such information also could describe when structural payment changes will occur (for example, when introductory rates expire or when amortizing payments are required) and what the new payment amount would be or how it would be calculated. As applicable, these descriptions could indicate that a higher payment may be required at other points in time due to factors such as negative amortization or increases in the interest-rate index.

Negative Amortization. When negative amortization is possible under the terms of a nontraditional mortgage product, consumers should be apprised of the potential for increasing principal balances and decreasing home equity, as well as other potential adverse consequences of negative amortization. For example, product descriptions should disclose the effect of negative amortization on loan balances and home equity, and could describe the potential consequences to the consumer of making minimum payments that cause the loan to negatively amortize. (One possible consequence is that it could be more difficult to refinance the loan or to obtain cash upon a sale of the home.)

Prepayment Penalties. If the institution may impose a penalty in the event that the consumer prepays the mortgage, consumers should be alerted to this fact and to the need to ask the

20. Consumers also should be apprised of other material changes in payment obligations, such as balloon payments.

lender about the amount of any such penalty.

Cost of Reduced Documentation Loans. If an institution offers both reduced and full documentation loan programs and there is a pricing premium attached to the reduced documentation program, consumers should be alerted to this fact.

Monthly Statements on Payment-Option ARMs. Monthly statements that are provided to consumers on payment-option ARMs should provide information that enables consumers to make informed payment choices, including an explanation of each payment option available and the impact of that choice on loan balances. For example, the monthly payment statement should contain an explanation, as applicable, next to the minimum payment amount that making this payment would result in an increase to the consumer's outstanding loan balance. Payment statements also could provide the consumer's current loan balance, what portion of the consumer's previous payment was allocated to principal and to interest, and, if applicable, the amount by which the principal balance increased. Institutions should avoid leading payment-option ARM borrowers to select a nonamortizing or negatively amortizing payment (for example, through the format or content of monthly statements).

Practices to Avoid. Institutions also should avoid practices that obscure significant risks to the consumer. For example, if an institution advertises or promotes a nontraditional mortgage by emphasizing the comparatively lower initial payments permitted for these loans, the institution also should provide clear and comparably prominent information alerting the consumer to the risks. Such information should explain, as relevant, that these payment amounts will increase, that a balloon payment may be due, and that the loan balance will not decrease and may even increase due to the deferral of interest or principal payments. Similarly, institutions should avoid promoting payment patterns that are structurally unlikely to occur.[21] Such practices could raise legal and other risks for institutions, as described more fully above.

Institutions also should avoid such practices as (1) giving consumers unwarranted assurances or predictions about the future direction of interest rates (and, consequently, the borrower's future obligations); (2) making one-sided representations about the cash savings or expanded buying power to be realized from nontraditional mortgage products in comparison with amortizing mortgages; (3) suggesting that initial minimum payments in a payment-option ARM will cover accrued interest (or principal and interest) charges; and (4) making misleading claims that interest rates or payment obligations for these products are "fixed."

Control Systems

Institutions should develop and use strong control systems to monitor whether actual practices are consistent with their policies and procedures relating to nontraditional mortgage products. Institutions should design control systems to address compliance and consumer information concerns as well as the safety and soundness considerations discussed in this guidance. Lending personnel should be trained so that they are able to convey information to consumers about product terms and risks in a timely, accurate, and balanced manner. As products evolve and new products are introduced, lending personnel should receive additional training, as necessary. Lending personnel should be monitored to determine whether they are following these policies and procedures. Institutions should review consumer complaints to identify potential compliance, reputation, and other risks. Attention should be paid to appropriate legal review and to using compensation programs that do not improperly encourage lending personnel to direct consumers to particular products.

With respect to nontraditional mortgage loans that an institution makes, purchases, or services using a third party, such as a mortgage broker, correspondent, or other intermediary, the institution should take appropriate steps to mitigate risks relating to compliance and consumer information concerns discussed in this guidance. These steps would ordinarily include, among other things, (1) conducting due diligence and establishing other criteria for entering into and maintaining relationships with such third par-

21. For example, marketing materials for payment-option ARMs may promote low predictable payments until the recast date. Such marketing should be avoided in circumstances in which the minimum payments are so low that negative amortization caps would be reached and higher payment obligations would be triggered before the scheduled recast, even if interest rates remain constant.

ties, (2) establishing criteria for third-party compensation designed to avoid providing incentives for originations inconsistent with this guidance, (3) setting requirements for agreements with such third parties, (4) establishing procedures and systems to monitor compliance with applicable agreements, bank policies, and laws, and (5) implementing appropriate corrective actions in the event that the third party fails to comply with applicable agreements, bank policies, or laws.

APPENDIX
(Terms Used in This Document)

Interest-Only Mortgage Loan. An interest-only mortgage loan refers to a nontraditional mortgage in which, for a specified number of years (for example, three or five years), the borrower is required to pay only the interest due on the loan, during which time the rate may fluctuate or may be fixed. After the interest-only period, the rate may be fixed or it may fluctuate based on the prescribed index and payments, including both principal and interest.

Payment-Option ARM. A payment-option ARM is a nontraditional adjustable-rate mortgage that allows the borrower to choose from a number of different payment options. For example, each month, the borrower may choose a minimum payment option based on a "start" or introductory interest rate, an interest-only payment option based on the fully indexed interest rate, or a fully amortizing principal and interest payment option based on a 15- or 30-year loan term, plus any required escrow payments. The minimum payment option can be less than the interest accruing on the loan, resulting in negative amortization. The interest-only option avoids negative amortization but does not provide for principal amortization. After a specified number of years, or if the loan reaches a certain negative amortization cap, the required monthly payment amount is recast to require payments that will fully amortize the outstanding balance over the remaining loan term.

Reduced Documentation. Reduced documentation is a loan feature that is commonly referred to as "low doc/no doc," "no income/no asset," "stated income," or "stated assets." For mortgage loans with this feature, an institution sets reduced or minimal documentation standards to substantiate the borrower's income and assets.

Simultaneous Second-Lien Loan. A simultaneous second-lien loan is a lending arrangement where either a closed-end second lien or a home equity line of credit is originated simultaneously with the first-lien mortgage loan, typically in lieu of a higher down payment.

Nontraditional Mortgages—Associated Risks Examination Objectives

Effective date May 2007

Section 2136.2

1. To ascertain if the bank has adequate risk-management processes, policies, and procedures to address the risk associated with its nontraditional mortgage loans.
2. To evaluate whether the bank's nontraditional mortgage loan terms are supported by a disciplined analysis of its potential exposures versus the mitigating factors that ensure that risk levels are adequately managed.
3. To determine if the underwriting standards for nontraditional mortgage loans comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines.
4. To evaluate whether the bank's management carefully considers and appropriately assesses and mitigates the risk exposures created by the nontraditional mortgage loans by ensuring that—
   a. its loan terms and underwriting standards are consistent with prudent lending practices, including consideration of a borrower's repayment capacity;
   b. its nontraditional mortgage loan products have strong risk-management standards, capital levels commensurate with the risk, and an allowance for loan and lease losses that reflects the collectibility of the portfolio; and
   c. its consumers have sufficient information to clearly understand the loan terms and associated risks prior to making a nontraditional mortgage loan product choice.
5. To determine if the bank has borrower qualification criteria that include an evaluation of a borrower's repayment capacity and ability to repay the debt—the full amount of the credit extended, including any balance increase that may accrue from negative amortization—by the final maturity date at the fully indexed rate.

RISK MITIGATION

1. Assess the bank's management procedures to mitigate the risk created by nontraditional mortgage products. Determine that—
   a. underwriting standards and terms are consistent with prudent lending practices, including consideration of each borrower's repayment capacity;
   b. products are supported by strong risk-management standards, capital levels that are commensurate with their risk, and an allowance for loan and lease losses that reflects the collectiblity of the portfolio; and
   c. borrowers have sufficient information to clearly understand the terms of their loans and their associates risks.

UNDERWRITING STANDARDS

1. Determine if the bank's underwriting standards—
   a. address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins,
   b. comply with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines, and
   c. require that loan terms are based on a disciplined analysis of potential exposures and mitigating factors, which will ensure that risk levels remain manageable.
2. Verify that the bank's nontraditional mortgage loan qualification standards recognize the potential impact of payment shock (particularly for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores).
3. Ascertain that the analysis of a borrower's repayment capacity includes—
   a. an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule,
   b. a repayment schedule that is based on the initial loan amount plus any balance increase that may accrue from a negative amortization provision, and
   c. avoiding an overreliance on credit scores as a substitute for income verification or a reliance on the sale or refinancing of the property (pledged as collateral) when amortization begins.
4. Determine whether originated or purchased mortgage loans that combine nontraditional features (such as interest-only loans with reduced documentation and second-lien loans) have mitigating factors (that is, higher credit scores, lower LTVs and DTI repayment ratios, significant liquid assets, mortgage insurance, or other credit enhancements) that support the underwriting decisions and the borrower's repayment capacities.
5. Verify that the bank has clear loan underwriting policies governing the use of—

   a. reduced documentation of the borrower's financial capacity (for example, non- verification of reported income when the borrower's income can be documented based on recent W-2 statements, pay stubs, or tax returns);

   b. minimal or no owner's equity for second-lien home equity lines of credit (such loans generally should not have a payment structure allowing for delayed or negative amortization without other significant risk-mitigating factors);

   c. introductory interest rates (banks should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates);

   d. subprime lending (adherence to the interagency guidance on subprime lending);[1] and

   e. non-owner-occupied investor loans (qualifications should be based on the borrower's ability to service the debt over the life of the loan, which would include a combined LTV ratio that considers negative amortization and sufficient borrower equity, and continuing cash reserves).

1. See SR-01-4 and SR-99-6.

PORTFOLIO AND RISK-MANAGEMENT PRACTICES

1. If the bank originates or invests in nontraditional mortgage loans, determine if more robust risk-management practices have been adopted to manage the exposures.
   a. Verify that there are appropriate written lending policies that have been adopted and are being used and monitored, specifying acceptable product attributes, production and portfolio limits (growth and volume limits by loan type), sales and securitization practices, and risk-management expectations (acceptable levels of risk).
   b. Determine if enhanced performance measures have been designed and if there is management reporting that provides an early warning for increasing risk.
   c. Find out if the appropriate levels for the allowance for loan and lease losses (ALLL) have been established that consider the credit quality of the portfolio and the conditions that affect collectibility.
   d. Evaluate whether adequate capital is maintained at levels that reflect portfolio characteristics and the effect of stressed economic conditions on collectibility.
   e. Determine if capital is held commensurate with the risk characteristics of the bank's nontraditional mortgage loan portfolios.
2. If the bank has concentrations in nontraditional mortgage products, determine if there are—
   a. well-developed monitoring systems and risk-management practices that monitor and keep track of concentrations in key portfolio segments, such as by loan type, third-party originations, geographic area, and property occupancy status, and
   b. systems that also monitor key portfolio characteristics: non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features.
3. Determine if the bank has adequate quality controls as well as compliance and audit procedures that focus on mortgage lending activities posing high risk.
   a. Determine if the bank has strong internal controls over accruals, customer service, and collections.
   b. Verify that policy exceptions made by servicing and collections personnel are carefully monitored and that practices such as re-aging, payment deferrals, and loan modifications are not inadvertently increasing risk.
   c. Find out if the quality control function regularly reviews (1) a sample of nontraditional mortgage loans from all origination channels and (2) a representative sample of underwriters confirming that underwriting policies are followed.
4. Bank oversight of third-party originators—
   a. determine if the bank has strong systems and controls in place for establishing and maintaining relationships with third-party nontraditional mortgage loan originators, including procedures for due diligence, and
   b. find out if the oversight of third- party mortgage loan origination lending practices includes monitoring the quality of originations (that is, the quality of origination sources, key borrower characteristics, appraisals, loan documentations, and credit repayment histories) so that they are reflective of the bank's lending standards and in compliance with applicable laws and regulations.
5. Determine if the bank's risk-management practices are commensurate with the nature, volume, and risk of its secondary-market activities.
   a. Find out if there are comprehensive formal strategies for managing the risks arising from significant secondary-market activities.
   b. Ascertain if contingency planning includes how the bank will respond to a decline in loan demand in the secondary market.
   c. Determine if there were any repurchases of defaulted mortgages and if the bank complies with its risk-based capital guidelines.
6. Evaluate the appropriateness of management information and reporting systems for the level and nature of the bank's mortgage lending activity.
   a. Verify that the reporting allows management to detect changes in the risk profile, or deteriorating performance, of its nontraditional mortgage loan portfolio.

b. Determine if management information is reported and available by loan type, risk-layering features, underwriting characteristics, and borrower performance.
c. Find out if—
   1) portfolio volume and performance are tracked against expectations, internal lending standards, and policy limits;
   2) volume and performance expectations are established at the subportfolio and aggregate portfolio levels;
   3) variance analyses are regularly performed to identify exceptions to policies and prescribed thresholds; and
   4) qualitative analyses are performed when actual performance deviates from established policies and thresholds.
d. Determine if the bank, based on the size and complexity of its lending operations, performs sensitivity analysis on its key portfolio segments to identify and quantify events that may increase its risks in a segment or the entire portfolio.
e. Verify that the scope of the sensitivity analysis includes stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the bank's immediate control.
f. Find out if the stress testing results provide direct feedback for determining underwriting standards, product terms, portfolio concentration limits, and capital levels.
g. Determine if the bank has established an appropriate ALLL for the estimated credit losses and commensurate capital levels for the risk inherent in its nontraditional mortgage loan portfolios (considering the higher risk of loss posed by the layered risks).
h. If the bank has material mortgage banking activities and mortgage servicing assets—
   a. evaluate whether sound practices were applied in valuing the mortgage servicing rights for its nontraditional mortgages and
   b. ascertain if the valuation process followed the nontraditional mortgage and other interagency guidance and generally accepted accounting principles, and whether reasonable and supportable assumptions were used.

Review the bank's internal controls, policies, procedures, and practices for making and servicing nontraditional mortgage loans. The bank's internal control 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.

RISK MANAGEMENT AND RISK MITIGATION

1. Are there procedures established to control, limit, and monitor the authorization of nontraditional mortgage loan transactions and to establish the appropriate supervision and preliminary review of nontraditional mortgage loan decisions?
2. For nontraditional mortgage loans, is there an appropriate separation of the employees' duties involving (1) the authorizing, executing, recording, and adjusting of loans, (2) receiving payments, (3) reconciling the accounts, and (4) maintaining clear title to, and custody of, pledged collateral—all to safeguard against the possible misappropriation of the bank's funds?
3. Has the bank's management developed risk-mitigation procedures for nontraditional mortgage products? If so, do the risk-mitigation procedures—
   a. set forth underwriting standards and terms that are consistent with prudent lending practices, including the consideration of each borrower's repayment capacity, third-party credit reports, pledged collateral valuations, and regularly timed follow-up reviews thereon?
   b. require that nontraditional mortgage products be supported by appropriate supervisory oversight and review, strong risk-management standards, capital levels that are commensurate with their risk, and an adequate allowance for loan and lease losses (ALLL) that reflects the collectibility of the portfolio?
   c. require that borrowers be provided with sufficient information so they can clearly understand the terms of their loans and their associated risks?

UNDERWRITING STANDARDS

1. Do the bank's underwriting standards—
   a. appropriately address and assess the effect of a substantial payment increase in the borrower's capacity to repay when loan amortization begins?
   b. establish practices consistent with the Federal Reserve's real estate lending standards and appraisal regulations and associated guidelines?
   c. require that loan terms be based on a disciplined analysis of potential exposures and mitigating factors, which will ensure that risk levels will remain manageable?
2. Does the bank's nontraditional mortgage loan qualification standards recognize the potential impact of payment shock, particularly for borrowers with high loan-to-value (LTV) ratios, high debt-to-income (DTI) ratios, and low credit scores?
3. Does the analysis of a borrower's repayment capacity include—
   a. an evaluation of the borrower's ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule?
   b. a repayment schedule that is based on the initial loan amount plus any balance increase that may accrue from a negative amortization provision?
   c. an avoidance of overreliance on credit scores as a substitute for income verification or reliance on the sale or refinancing of the property when amortization begins?
4. Do originated or purchased mortgage loans that combine nontraditional features (such as interest-only loans with reduced documentation and second-lien loans) have mitigating factors (that is, higher credit scores, lower LTVs and DTI repayment ratios, significant liquid assets, mortgage insurance, or other credit enhancements) that support the underwriting decisions and the borrower's repayment capacities?
5. Are there clear bank loan underwriting policies governing the use of—
   a. reduced documentation of the borrower's financial capacity (for example, non-

verification of reported income when the borrower's income can be documented based on recent W-2 statements, pay stubs, or tax returns)?
b. minimal or no owner's equity for second-lien home equity lines of credit (such loans generally should not have a payment structure allowing for delayed or negative amortization without other significant risk-mitigating factors)?
c. introductory interest rates (banks should minimize the likelihood of disruptive early recastings and extraordinary payment shock when setting introductory rates)?
d. subprime lending (including underwriting policies that are consistent with the interagency guidance on subprime lending)[1]?
e. non-owner-occupied investor loans (the qualifications should be based on the borrower's ability to service the debt over the life of the loan, which would include a combined LTV ratio that would consider negative amortization and sufficient borrower equity, and continuing cash reserves)?

PORTFOLIO AND RISK-MANAGEMENT PRACTICES

1. If the bank originates or invests in nontraditional mortgage loans—
   a. has the bank adopted risk-management practices to keep pace with the growth and changing risk profile of its nontraditional loan portfolio?
   b. are there appropriate bank-adopted (and monitored) written lending policies in use that specify—
      - acceptable product attributes?
      - production and portfolio limits (growth and volume limits by loan type)?
      - sales and securitization practices?
      - risk-management expectations (acceptable levels of risk)?
   c. have enhanced performance measures been designed and is there management reporting that will provide an early warning of increasing risk?
   d. are there appropriate ALLL levels established that consider the credit quality of the portfolio and the conditions that affect collectibility?
   e. is the bank's capital maintained at a level that is adequate and commensurate with the characteristics of its nontraditional mortgage loan portfolio, including the effect of stressed economic conditions on the collectibility of such loans?
2. If the bank has concentrations in nontraditional mortgage products, are there—
   a. well-developed monitoring systems and risk-management practices that monitor and keep track of concentrations in key portfolio segments, such as by loan type, third-party originations, geographic area, and property occupancy status?
   b. systems that also monitor key portfolio characteristics: non-owner-occupied investor loans and loans with (1) high combined LTV ratios, (2) high DTI ratios, (3) the potential for negative amortization, (4) credit scores of borrowers that are below established thresholds, and (5) risk-layered features?
3. Does the bank have adequate quality controls, including an independent internal loan review staff, that will consider and review loan documentation and other compliance and audit procedures that focus on mortgage lending activities posing high risk? Are there—
   a. strong internal controls over accruals, customer service, and collections?
   b. reviews of policy exceptions, conducted by servicing and collections personnel, which are carefully monitored, and are practices such as re-aging, payment deferrals, and loan modifications regularly reviewed to ensure that they are not inadvertently increasing risk?
   c. regular reviews conducted by the quality control function that focus on (1) a sample of nontraditional mortgage loans from all origination channels and (2) a representative sample of underwriters to confirm that underwriting policies are followed?
4. Bank oversight of third-party originators—
   a. Does the bank have strong internal systems and controls in place for establishing and maintaining relationships with third-party nontraditional mortgage loan

1. See SR-01-4 and SR-99-6.

originators, including procedures for due diligence?

b. Are there staff designated to provide bank oversight of third-party mortgage loan origination lending practices, which include the monitoring of the quality of originations (that is, the quality of origination sources, key borrower characteristics, appraisals, loan documentations, and credit repayment histories) to ensure that the originations (1) reflect adherence to the bank's lending standards and (2) compliance with applicable laws and regulations?

5. Are the bank's risk-management practices for nontraditional mortgage loans commensurate with the nature, volume, and risk of its secondary-market activities? If so, are there—
   a. comprehensive formal strategies for managing the risks arising from significant secondary-market activities?
   b. bank contingency plans that include how the bank will respond to a decline in loan demand in the secondary market?
   c. repurchases of defaulted mortgages and, if so, is the bank in compliance with its riskbased capital guidelines?

MANAGEMENT INFORMATION SYSTEM

1. Are the bank's management information system (MIS) and reports appropriate for the level and nature of the bank's nontraditional mortgage lending activity?
2. Do the systems and reports allow management to detect changes in the risk profile of, or deteriorating performance in, its nontraditional mortgage loan portfolio?
3. For the bank's nontraditional loan portfolio, is management information reported and available by loan type, risk-layering features, underwriting characteristics, and borrower performance?
4. Is the bank's nontraditional mortgage portfolio's—
   a. volume and performance tracked against expectations, internal lending standards, and policy limits?
   b. volume and performance expectations established at the sub portfolio and aggregate portfolio levels?
   c. variance analyses regularly performed to identify exceptions to policies and prescribed thresholds?
   d. qualitative analyses performed when actual performance deviates from established policies and thresholds?
5. Does the bank's MIS provide reports consisting of a trial balance of the borrower's loan balances, and an aged trial balance (based on the borrower's loan repayment terms), for the entire loan portfolio (the totals of which agree with the bank's respective general ledger balance[s]), but with nontraditional mortgage loan balances segregated and subtotaled (or totaled)?
6. Does the bank, based on the size and complexity of its lending operations, perform sensitivity analysis on its key portfolio segments to identify and quantify events that may increase its risks in a segment or the entire portfolio?
7. Does the scope of the sensitivity analysis include stress tests on key performance drivers such as interest rates, employment levels, economic growth, housing value fluctuations, and other factors beyond the bank's immediate control?
8. Do the stress testing results provide direct feedback for determining underwriting standards, product terms, portfolio concentration limits, and capital levels?
9. Has the bank established and maintained an appropriate ALLL for the estimated credit losses on nontraditional mortgage loans?
10. Do designated supervisory personnel periodically review adjustments to, and of, past due and charged-off nontraditional mortgage loans to confirm that appropriate actions have been taken, including collections and recoveries?
11. Does the bank have commensurate capital levels for the risk inherent in its nontraditional mortgage loan portfolios (considering the higher risk of loss posed by the layered risks)?
12. If the bank has material mortgage banking activities and mortgage servicing assets—
    a. has it evaluated whether sound practices were applied in valuing the mortgage servicing rights for its nontraditional mortgages?
    b. does the bank's valuation process follow the nontraditional mortgage and other interagency guidance and generally accepted accounting principles, and have

reasonable and supportable assumptions been used?

CONCLUSION

1. With respect to the bank's management of its nontraditional mortgage loan portfolio, is there adequate separation of duties, proper authorization of transactions and activities, adequate documents and records, physical control over assets and records, and independent checks on performance?
2. Have any responses to the forgoing information revealed any significant deficiencies and weaknesses in the bank management's system of internal controls over its nontraditional mortgage loan portfolio—weaknesses that effect controls over risk management and assessment, the reliability of financial reporting, the accounting information and communication system, efficiency and effectiveness of operations, compliance with laws and regulations, and monitoring of internal control performance?
3. Are there any internal control deficiencies in areas that are not covered within this questionnaire that impair any controls? Explain any additional examination procedures that are, or would be, necessary to draw conclusions about the adequacy of the internal controls over the bank's nontraditional mortgage loans.
4. Based on an overall evaluation, as evidenced by your answers to the foregoing questions, are internal controls over the bank's nontraditional mortgage loans adequate or inadequate?

LOAN-BROKERAGE AND -SERVICING ACTIVITIES

Loan-brokerage and -servicing activities are undertaken by mortgage banking enterprises and the mortgage banking operations of commercial banks. Mortgage banking activities consist primarily of two separate but related activities: (1) the origination or acquisition of mortgage loans and the sale of the loans to permanent investors and/or (2) the subsequent long-term servicing of the loans. A mortgage banking enterprise usually retains the right to service mortgage loans it sells to permanent investors. An enterprise's right to service mortgage loans other than its own is an intangible asset that may be acquired separately. The rights to service mortgage loans are purchased and sold frequently. Mortgage loans are acquired to sell to permanent investors from a variety of sources, including applications received directly from borrowers (in-house originations), purchases from brokers, purchases from investors, and conversions of various forms of interim financing to permanent financing. A service fee, usually based on a percentage of the outstanding principal balance of the mortgage loan, is received for performing loan-administration functions. When servicing fees exceed the cost of performing servicing functions, the existing contractual right to service mortgage loans has economic value.

A number of bank services may result in assets and liabilities that do not have to be entered on the general ledger. These services are considered off-balance-sheet activities and may include the origination, sale, and servicing of various loans. Servicing and accounting activities cover functions related initially to recording the loan, collecting and recording payments, and reporting loan transactions and balances (including reporting past due loans). Unlike the other activities in this section, servicing and accounting activities are not directly related to credit risk. However, some aspects of accounting and servicing activities, such as the accounting system's ability to produce accurate past due loan reports, indirectly contribute to controlling credit risk. Also, poorly designed or ineffective servicing and accounting activities can contribute to increased risk in areas besides credit, such as fraud and insider abuse.

The origination, sale, and servicing of various types of loans usually have been associated with mortgage loans. But increasingly, origination and servicing activities have also been observed in government-guaranteed loans (or portions thereof), consumer loans, and commercial loans. Improper management and control of these activities by the servicer presents certain supervisory concerns. If the bank servicer is continually originating additional loans to be serviced, the bank may find itself responsible for servicing more loans than it can prudently manage. Failure to properly administer loans may lead to legal or financial liabilities that could adversely affect the bank's capital.

ACCOUNTING GUIDANCE

The following accounting pronouncements issued by the Financial Accounting Standards Board (FASB) apply to mortgage banking activities:

- FAS 5, Accounting for Contingencies
- FAS 65, Accounting for Certain Mortgage Banking Activities
- FAS 91, Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
- FAS 115, Accounting for Certain Investments in Debt and Equity Securities (paragraph 7 was amended by FAS 140)
- FAS 133, Accounting for Derivative Instruments and Hedging Activities (amended by FAS 140)
- FAS 134, Accounting for Mortgage-Backed Securities Retained After the Securitization of Mortgage Loans Held for Sale by a Mortgage Banking Enterprise
- FAS 138, Accounting for Certain Derivative Instruments and Certain Hedging Activities
- FAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities
- FAS 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities
- FAS 154, Accounting Changes and Error Corrections

The accounting standards for nonrefundable fees and costs associated with lending, committing to lend, and purchasing a loan or group of loans are set forth in FASB Statement No. 91, “Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases,” (FAS 91). A summary of the statement follows. The statement applies to all types of loans as well as to debt securities (but not to loans or debt securities carried at market value if the changes in market value are included in earnings) and all types of lenders.

Nonrefundable loan fees paid by the borrower to the lender may have many different names, such as origination fees, points, placement fees, commitment fees, application fees, management fees, restructuring fees, and syndication fees. FAS 91 applies to both a lender and a purchaser and should be applied to individual loan contracts. Aggregation of similar loans for purposes of recognizing net fees or costs, purchase premiums, or discounts is permitted under certain circumstances specified in FAS 91, or if the result does not differ materially from the amount that would have been recognized on an individual loan-by-loan basis. In general, FAS 91 specifies the following:

- Loan-origination fees should be deferred and recognized over the life of the related loan as an adjustment of yield (interest income). Once a bank adopts FAS 91, recognizing a portion of loan fees as revenue to offset all or part of origination costs in the reporting period in which a loan is originated is no longer acceptable.
- Certain direct loan-origination costs specified in FAS 91 should be deferred and recognized over the life of the related loan as a reduction of the loan’s yield. Loan-origination fees and related direct loan-origination costs for a given loan should be offset and only the net amount deferred and amortized.
- Direct loan-origination costs should be offset against related commitment fees, and the net amounts should be deferred except for
  - — commitment fees (net of costs) when the likelihood that the commitment will be exercised is remote; in these cases, the fees should generally be recognized as service-fee income on a straight-line basis over the loan-commitment period, and
  - — retrospectively determined fees, which are recognized as service-fee income when the amount of the fees are determined.

All other commitment fees (net of costs) are to be deferred over the entire commitment period and recognized as an adjustment of yield over the related loan’s life or, if the commitment expires unexercised, recognized in income upon expiration of the commitment.

- Loan-syndication fees should be recognized by the bank managing a loan syndication (the syndicator) when the syndication is complete unless a portion of the syndication loan is retained. If the yield on the portion of the loan retained by the syndicator is less than the average yield to the other syndication participants after considering the fees passed through by the syndicator, the syndicator should defer a portion of the syndication fee to produce a yield on the portion of the loan retained that is not less than the average yield on the loans held by the other syndication participants.
- Loan fees, certain direct loan-origination costs, and purchase premiums and discounts on loans are to be recognized as an adjustment of yield generally by the interest method based on the contractual term of the loan. However, if the bank holds a large number of similar loans for which prepayments are probable and if the timing and amount of prepayments can be reasonably estimated, the bank may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. Fees should not be recognized over the estimated average life of a group of loans.

Examiners should review the extent and nature of servicing activities to ensure that they are conducted in a safe and sound manner. Loan-origination fees and related direct loan-origination costs of loans held for sale should be accounted for in accordance with FAS 91, as discussed above. Improper practices should be criticized.

RISK MANAGEMENT AND THE VALUATION AND HEDGING OF MORTGAGE-SERVICING ASSETS ARISING FROM MORTGAGE BANKING ACTIVITIES

A bank's board of directors and senior management are expected to take into account the potential exposure of both earnings and capital to changes in a bank's mortgage banking assets and operations under expected and stressed market conditions. Banks are expected to have comprehensive documentation that adequately substantiates and validates the carrying values of its mortgage-servicing assets (MSAs) and the underlying assumptions used to derive those values. The analyses and processes should be fully documented to support the amortization and timely recognition of impairment of the bank's MSAs. (See SR-03-4.)

The guidance that follows focuses on the risks associated with these aspects of mortgage banking: valuation and modeling processes, hedging activities, management information systems, and internal audit processes. When banks originate mortgage loans, they often sell the loans into the secondary market. Yet banks often retain and recognize the servicing of those MSAs, which are complex and volatile assets that are subject to interest-rate risk. MSAs can become impaired as interest rates fall and borrowers refinance or prepay their mortgage loans. This impairment can lead to earnings volatility and the erosion of capital, if the risks inherent in the MSAs are not properly hedged.

When accounting for MSAs, banks are expected to follow FAS 140, which requires the following accounting treatment for servicing assets (including MSAs):[1]

- initially record servicing assets at fair value, presumably the price paid if purchased, or at their allocated carrying amount based on relative fair values if retained in a sale or securitization;[2]
- amortize servicing assets in proportion to, and over the period of, estimated net servicing income; and
- stratify servicing assets based on one or more of the predominant risk characteristics of the underlying financial assets, assess the strata for impairment based on fair value, and report them on the balance sheet at the lower of unamortized cost or fair value through the use of valuation allowances.

Fair value is defined in FAS 140 as the amount at which an asset could be bought or sold in a current transaction between willing parties, that is, other than in a forced or liquidation sale. Quoted market prices in active markets for similar assets provide the best evidence of fair value and must be used as the basis for the measurement, if available. If quoted market prices are not available, the estimate of fair value must be based on the best information available. The estimate of fair value must consider prices for similar assets and the results of valuation techniques to the extent available.

Examination Concerns on the Valuation of Mortgage-Servicing Assets

Banks involved in mortgage-servicing operations should use market-based assumptions that are reasonable and supportable in estimating the fair value of servicing assets. Specifically, bulk, flow, and daily MSA/loan pricing activities observed in the market should be evaluated to ensure that a bank's MSA valuation assumptions are reasonable and consistent with market activity for similar assets. Many banks also use models to estimate the fair value of their MSAs and substantiate their modeled estimate of MSA fair value by comparing the model output with general or high-level peer surveys. Such a comparison, however, is often performed without adequate consideration of the specific attributes of the bank's own MSAs.

Examiners should consider the following concerns as an indication that additional scrutiny is necessary:

1. Further guidance on the accounting for servicing assets and liabilities can be found in the instructions for the Reports of Condition and Income (Call Report); FAS 140 FASB Staff Implementation Guide; and the AICPA Statement on Auditing Standards 101, "Auditing Fair Value Measurements and Disclosures."

2. FAS 140 indicates, "Typically, the benefits of servicing are expected to be more than adequate compensation to a servicer for performing the servicing, and the contract results in a servicing asset. However, if the benefits of servicing are not expected to adequately compensate a servicer for performing the servicing, the contract results in a servicing liability."

- The use of unsupported prepayment speeds, discount rates, and other assumptions in MSA valuation models.
  - Assumptions are unsupported when they are not benchmarked to market participants' assumptions and the bank's actual portfolio performance across each product type.
- Questionable, inappropriate, or unsupported items in the valuation models (examples include retention benefits,[3] deferred tax benefits, captive reinsurance premiums, and income from cross-selling activities).
  - The inclusion of these items in the MSA valuation must be appropriate under generally accepted accounting principles (GAAP) and must also be consistent with what a willing buyer would pay for the mortgage-servicing contract. For example, when the inclusion of retention benefits as part of the MSA valuation is not adequately supported with market data, such inclusion will result in an overstatement of reported mortgage-servicing assets. Therefore, the inclusion will be deemed an unsafe and unsound practice.
- Disregard of comparable market data coupled with overreliance on peer-group surveys as a means of supporting assumptions and the fair value of MSAs.
  - Management may use survey data for comparative purposes; however, such data are not a measure of or substitute for fair value.
- Frequent changing of assumptions from period-to-period for no compelling reason, and undocumented policies and procedures relating to the MSA valuation process and oversight of that process.
- Inconsistencies in the MSA valuation assumptions used in valuation, bidding, pricing, and hedging activities as well as, where relevant, in mortgage-related activities in other aspects of a bank's business.
- Poor segregation of duties from an organizational perspective between the valuation, hedging, and accounting functions.
- Failure to properly stratify MSAs for impairment-testing purposes.
  - FAS 140 requires MSAs to be stratified based on one or more of the predominant risk characteristics of the underlying mortgage loans. Such characteristics may include financial asset type, size, interest rate, origination date, term, and geographic location. Banks are expected to identify a sufficient number of risk characteristics to adequately stratify each MSA and provide for a reasonable and valid impairment assessment. Stratification practices that ignore predominant risk characteristics are a supervisory concern.
- Inadequate amortization of the remaining cost basis of MSAs, particularly during periods of high prepayments.
  - Inadequate amortization often occurs because prepayment models are not adequately calibrated to periods of high prepayments. When these models underestimate runoff, the amount and period of estimated net servicing income are overstated.
- Continued use of a valuation allowance for the impairment of a stratum of MSAs when repayment of the underlying loans at a rate faster than originally projected indicates the existence of an impairment for which a direct write-down should be recorded.
- Failure to assess actual cash-flow performance. (The actual cash flows received from the serviced portfolio must be established in order to determine the benefit of MSAs to the bank.)
- Failure to validate or update models for new information.
  - Inaccuracies in valuation models can result in erroneous MSA values and affect future hedging performance. Models should be inventoried and periodically revalidated, including an independent assessment of all key assumptions.

RISK MANAGEMENT OF MORTGAGE BANKING ACTIVITIES

The Federal Reserve expects state member banks to perform mortgage banking operations in a safe and sound manner. Management should ensure that detailed policies and procedures are in place to monitor and control mortgage banking activities, including loan production, pipeline (unclosed loans) and warehouse (closed loans) administration, secondary-market transactions, servicing operations, and management

3. Retention benefits arise from the portion of the serviced portfolio that is expected to be refinanced with the bank in the future.

(including hedging) of mortgage-servicing assets. Reports and limits should focus on key risks, profitability, and proper accounting practices.

MSAs possess interest rate-related option characteristics that may weaken a bank's earnings and capital strength when interest rates change. Accordingly, banks engaged in mortgage banking activities should consider all aspects of the federal banking agencies' policy on interest-rate risk.[4] In addition, banks with significant mortgage banking operations or mortgage-servicing assets should incorporate these activities into their critical planning processes and risk-management oversight. The planning process should include careful consideration of how the mortgage banking activities affect the bank's overall strategic, business, and asset-liability plans. Risk-management considerations include the potential exposure of both earnings and capital to changes in the value and performance of mortgage banking assets under expected and stressed market conditions. Furthermore, a bank's board of directors should establish limits on investments in mortgage banking assets and evaluate and monitor such investment concentrations (on the basis of both asset and capital levels) on a regular basis.

During examinations of mortgage banking activities, examiners should review mortgage banking policies, procedures, and management information systems to ensure that the directors, managers, and auditors are adequately addressing the following matters.

Valuation and Modeling Processes

- Comprehensive documentation standards for all aspects of mortgage banking, including mortgage-servicing assets.
  - In particular, management should substantiate and validate the initial carrying amounts assigned to each pool of MSAs and the underlying assumptions as well as the results of periodic reviews of each asset's subsequent carrying amount and fair value. The validation process should compare actual performance with predicted performance. Management should ensure proper accounting treatment for MSAs on a continuing basis.

4. See SR-96-13, Joint Agency Policy Statement on Interest Rate Risk (June 26, 1996), and the Interest Rate Risk Management section.

- MSA impairment analyses that use reasonable and supportable assumptions.
  - Analyses should employ realistic estimates of adequate compensation,[5] future revenues, prepayment speeds, market-servicing costs, mortgage-default rates, and discount rates. Fair values should be based on market prices and underlying valuation assumptions for transactions in the marketplace involving similar MSAs. Management should avoid relying solely on peer-group surveys or the use of unsupportable assumptions. The Federal Reserve encourages banks to obtain periodic third-party valuations by qualified market professionals to support the fair values of their MSAs and to update internal models.
- Comparison of assumptions used in valuation models to the bank's actual experience in order to substantiate the value of MSAs.
  - Management should measure the actual performance of MSAs by analyzing gross monthly cash flows of servicing assets relative to the assumptions and projections used in each quarterly valuation. In addition, a comparison of the first month's actual cash received on new MSAs with the projected gross cash flows can help validate the reasonableness of initial MSA values prior to the impact of prepayments and discount rates. This analysis is a critical tool in understanding the profitability of mortgage servicing to a bank; however, it is not a substitute for the estimation of the fair value of MSAs under GAAP.
- Review and approval of results and assumptions by management.
  - Given the sensitivity of the MSA valuation to changes in assumptions and valuation policy, any such changes should be reviewed and approved by management and, where appropriate, by the board of directors.
- Comparison of models used throughout the company including valuation, hedging, pricing, and bulk acquisition.
  - Companies often use multiple models and assumption sets in determining the values

5. As defined in FAS 140, "adequate compensation" is "the amount of benefits of servicing (i.e., revenues from contractually specified servicing fees, late charges, and other ancillary sources) that would fairly compensate a substitute servicer should one be required, which includes the profit that would be demanded in the marketplace."

for MSAs depending on their purpose—pricing versus valuation. Any inconsistencies between these values should be identified, supported, and reconciled.
- Appropriate amortization practices.
  - — Amortization of the remaining cost basis of MSAs should reflect actual prepayment experience. Amortization speeds should correspond to and be adjusted to reflect changes in the estimated remaining net servicing income period.
- Timely recognition of impairment.
  - — Banks must evaluate MSAs for impairment at least quarterly to ensure amounts reported in the call report[6] are accurately stated. Banks will generally be expected to record a direct write-down of MSAs when, and for the amount by which, any portion of the unamortized cost of a mortgage-servicing asset is not likely to be recovered in the future.

Mortgage Banking Hedging Activities

- Systems to measure and control interest-rate risk.
  - — Hedging activities should be well developed and communicated to responsible personnel. Successful hedging systems will mitigate the impact of prepayments on MSA values and the effects of interest-rate risk in the mortgage pipeline and warehouse.
- Approved hedging products and strategies.
  - — Management should ensure appropriate systems and internal controls are in place to oversee hedging activities, including monitoring the effectiveness of hedging strategies and reviewing concentrations of hedge instruments and counterparties.
- Hedge accounting policies and procedures.
  - — Banks should ensure their hedge accounting methods are adequately documented and consistent with GAAP.

Management Information Systems

- Accurate financial reporting systems, controls, and limits.
  - — At a minimum, the board should receive information on hedged and unhedged positions, mark-to-market analyses, warehouse aging, the valuation of MSAs, various rate shock-scenario and risk exposures, the creation of economic value, and policy exceptions whenever material exposure to MSAs exists.
- Systems that track quality-control exceptions.
  - — Quality-control reports should be analyzed to determine credit quality, loan characteristics and demographics, trends, and sources of problems. Sound quality-control programs are also beneficial in the early detection of deteriorating production quality and salability as well as in the prevention and detection of fraudulent activities.
- Systems that track and collect required mortgage loan documents.
  - — Management should ensure adequate control processes are in place for both front-end-closing and post-closing loan documents. If mortgages are not properly documented, a bank may be forced to hold unsold mortgages for extended periods or repurchase mortgages that have been sold. Further, management should ensure that adequate analyses are performed and allowances are established for estimated probable losses arising from documentation deficiencies on closed loans.
- Systems that monitor and manage the risks associated with third-party originated loans.
  - — Banks often originate loans through broker and correspondent channels. Management should ensure that prudent risk-management systems are in place for broker and correspondent approvals and ongoing monitoring, including controls on the appraisal and credit-underwriting process of third-party originated loans. Adequate due diligence of third-party relationships is necessary to help prevent the origination of loans that are of poor credit quality or are fraudulent. Delegated underwriting to brokers or correspondents warrants close supervision from senior management.

Internal Audit

- Adequate internal audit coverage.
  - — Because of the variety of risks inherent in mortgage banking activities, internal audi-

6. Schedule RC-M, Memoranda, Item 2a.

tors should evaluate the risks of and controls over their bank's mortgage banking operations. They should report audit findings, including identified control weaknesses, directly to the audit committee of the board or to the board itself. Board and management should ensure that internal audit staff possess the necessary qualifications and expertise to review mortgage banking activities or obtain assistance from qualified external sources.

INTERAGENCY ADVISORY ON ACCOUNTING AND REPORTING FOR COMMITMENTS TO ORIGINATE AND SELL MORTGAGE LOANS

On May 3, 2005, the Federal Reserve, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, and the former Office of Thrift Supervision issued an "Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans." The advisory provides guidance on the appropriate accounting and reporting for commitments to

- originate mortgage loans that will be *held for resale,* and
- sell mortgage loans under mandatory-delivery and best-efforts contracts.

The advisory discusses the characteristics that should be considered in determining whether mandatory-delivery and best-efforts contracts are derivatives and the accounting and regulatory reporting treatment for both commitments to originate mortgage loans that will be held for resale and those loan-sales agreements that meet the definition of a derivative. The advisory also addresses the guidance that should be considered in determining the fair value of derivatives.

A financial institution is expected to account for and report derivative loan commitments and forward loan-sales commitments as derivatives in accordance with GAAP, which includes the use of valuation techniques that are reasonable and supportable in the determination of fair value. An institution's failure to account for and report derivative loan commitments and forward loan-sales commitments in regulatory reports in accordance with GAAP may be an unsafe and unsound practice. To view the entire contents of the advisory, see SR-05-10, "Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans."

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Mortgage Banking

INTRODUCTION

Agricultural loans can be broadly defined as loans made to agricultural producers to finance the production of crops or livestock. The term ‘‘crops’’ is meant to include any of the many types of plants that produce grains, fruits, vegetables, or fibers that can be harvested. Similarly, a variety of animals is produced for profit, although cattle, swine, sheep, and poultry are by far the most common. Production cycles vary with the type of crop or livestock, from a few weeks or months to several years; in the case of an orchard crop or timber, the time from planting to harvest (from cash outlay to the generation of income) is quite lengthy. The type of crop or livestock to be produced will determine the nature of the financing needed, including its timing, collateral considerations, and repayment terms.

Repayment terms for farm loans normally correspond to anticipated cash flows. Since repayment of agricultural-related loans usually comes from the sale of crops or livestock, annual repayment terms are not uncommon. Depending on the type of operation and timing of cash income, payments may be set to come due semiannually, quarterly, or on an irregular schedule. However, many smaller farm operators also receive income from nonfarm employment, which allows them to make monthly payments on some loans.

Agricultural producers need access to land (often with buildings and other improvements) and equipment, in addition to the shorter-term operating inputs directly involved in crop or livestock production. Not all producers own land; some are tenants who pay the landowners cash rent or a portion of the crop yield. Many producers both own and rent or lease land in an effort to maximize efficiency and income. Accordingly, individual producers may need a variety of types of loans, including—

- real estate loans,
- equipment loans,
- livestock loans, and
- operating (or production) loans.

Information on each of these types of agricultural loans follows, as well as general comments on agricultural lending and the examiner’s review of agricultural loans.

AGRICULTURAL REAL ESTATE LOANS

Real estate loans are not intended as a primary focus of this manual section. However, real estate loans are a significant portion of total debt for many agricultural producers, and the examiner should consider them when evaluating other types of loans to agricultural producers. For a more thorough discussion of real estate loans, refer to section 2090.1, ‘‘Real Estate Loans.’’ Loans to finance agricultural land, together with related improvements (frequently including the producer’s residence) comprise the most common type of real estate loan made by agricultural banks. These loans are subject to the same general lending principles and legal and regulatory requirements[1] as loans on other types of real estate. Even if a bank has not made a real estate loan to the agricultural borrower, any real estate debt owed elsewhere must be considered in analyzing the borrower’s creditworthiness, along with amounts due to the bank and any other creditors. Additionally, any state laws on homestead exemptions should be noted.

Agricultural real estate loans tend to have special characteristics, particularly with regard to valuation and repayment considerations. For instance, farmland appraisers need special knowledge of soil types, topography, data on rainfall or water tables, and crop production data, as well as a knowledge of area market conditions and other extenuating information. Prevailing market values for farmland tend not to permit as high a level of cash return as those for other types of income-producing property. Values always reflect supply and demand, and, probably due to a number of factors, the demand for farmland has traditionally been relatively strong from neighboring landowners, other area farmers, nonfarmers, and absentee owners who have a strong desire to own land. A lower level of return generally dictates a lower loan-to-value ratio, although a borrower may be able to

1. In connection with the supervisory loan-to-value limits set forth in the ‘‘Interagency Guidelines for Real Estate Lending Policies,’’ farmland, ranchland, or timberland committed to ongoing management and agricultural production is considered ‘‘improved property,’’ subject to a loan-to-value limit of 85 percent. However, a bank may set a lower limit for itself and, as a matter of policy, probably will loan less than 85 percent of appraised value on farmland in most cases.

service debt at a higher level from other income sources such as less-heavily encumbered land, rented land, or nonfarm income. For example, it would not be unusual for a bank to advance 100 percent of the purchase price of land if a lien on additional land is taken to lower the overall loan-to-value ratio.

There is generally a well-established market for agricultural land. Although values fluctuate based on a variety of factors (just as they do with other types of real estate), there is normally a recognized range of values at any given time for particular land types within a general area. The examiner should gain some knowledge of current area land prices and trends through published data from local universities or private organizations, interviews with bank management, and the review of appraisal reports. This knowledge will be vital in assessing collateral values and the borrower's overall financial condition and future prospects.

An amortization period of up to 20 years is not uncommon for agricultural real estate loans by banks. Longer-term loans (up to 30 years) on farm real estate are sometimes made by commercial banks, but are more common with other lenders such as Federal Land Banks. Many banks structure real estate loans so that required payments are based on a 20- to 30-year amortization, but they write the notes with a 5- to 10-year maturity, at which time a balloon payment is due. Major improvements, such as livestock-confinement buildings or grain-handling facilities, commonly have a shorter amortization period of 10 years or less.

AGRICULTURAL MACHINERY AND EQUIPMENT LOANS

Agricultural producers often need to finance the purchase of machinery, equipment, vehicles, and implements. Typically, these loans are secured by the durable goods being financed and are amortized over an intermediate term of up to seven years. As with any equipment loan, some borrower equity should be required, the amortization period should be no longer than the expected useful life of the equipment, and scheduled payments should correlate reasonably with the timing and amount of anticipated income. In some cases, equipment loan payments may be advanced under the borrower s operating line of credit.

Loans to farmers and ranchers may include individual notes to finance the purchase of specific pieces of equipment or vehicles. However, many agricultural borrowers provide the bank with a blanket lien on all equipment and vehicles to secure any and all debts owed the bank. Frequently, borrowers have both purchase money loans on specific equipment and other loans secured by a blanket equipment lien.

Under the Uniform Commercial Code, a security interest in equipment is created with a security agreement signed by the borrower and a bank officer, and the lien is perfected by a centrally filed financing statement. Many banks file the financing statement in both the county and state in which the borrower resides *and* in the county and state in which the equipment is located. The filing is a public record that notifies lenders or other interested parties that the assets identified have been pledged, as well as to whom and when they were pledged.

Since the filing record provides vital information for potential lenders, bank management must check it before extending credit to determine whether the collateral is already pledged to another lender. In many cases, a bank might approve a loan request only if it were to be in a first lien position, but there can be exceptions. For example, a bank may agree to advance on a second lien position in a large piece of equipment in which the borrower has substantial equity or take a blanket lien on all equipment, including one or a few items of equipment pledged elsewhere (such as a purchase money lien held by an equipment dealer). As a matter of prudent lending and sound loan administration, lien searches should be performed periodically on at least larger borrowers or on those borrowers known to be or suspected of having problems or of being involved with other lenders.

Sound bank lending policies should prescribe a maximum loan-to-value ratio for equipment, as well as maximum repayment terms. The same is true for vehicles, although the loan-to-value limits on vehicles for highway use (automobiles and trucks) tend to be higher because they have a less-specialized use and are more liquid. Maximum loan-to-value limits, particularly for loans to purchase specific pieces of farm equipment, may range to more than 80 percent or even to 100 percent for strong borrowers. However, many farm lines of credit are supported in part by blanket liens on all the borrower's equipment. Typically, overall loan-to-value ratios on a line of equipment do not exceed 60 percent.

LIVESTOCK LOANS

Livestock loans vary with the animal species and the nature of the individual producer's operation, but the same general lending principles apply to virtually all types of livestock loans. The borrower should have an equity position in the livestock financed, ample feed on hand, or another underlying financial strength that will protect the lender from risks such as losses from animal diseases and deaths, rising feed costs, or market fluctuations. The size of the livestock operation should be commensurate with the borrower's physical facilities and management capability. Total debt should not overburden the borrower, and the timing and source of repayment for loans should be understood when they are originated. The term of a livestock loan normally bears a close relationship to the length of time the animals are to be held.

Feed is a necessity for livestock producers and a major expense for those involved in finishing animals for slaughter, dairy herds, or egg-laying operations. On the other hand, stocker cattle feed mainly on pasture or silage, which reduces feed costs. Some livestock producers also raise feed crops, which may improve their overall efficiency. Many producers, however, need to buy feed. In any event, the loan officer should have a firm understanding of how much feed the borrower has on hand (or will be harvesting) and how much will have to be purchased. Still, even though both borrower and banker may be experienced and capable at projecting feed costs, variables beyond their control impose some risk of increased costs. These variables might include perils such as unfavorable weather or disease affecting feed crop yields or rising feed prices or shortages brought on by other unanticipated forces.

Many banks will advance up to 100 percent of the cost of livestock if the borrower has sufficient feed on hand and a sound overall financial position. Since the animals gain weight and value as feedstocks are consumed, the bank's collateral position normally strengthens as the livestock matures toward market weight. For borrowers without adequate feedstocks on hand, advance rates may be limited to 70 to 80 percent of the purchase price.

TYPES OF LIVESTOCK OPERATIONS AND LOAN CONSIDERATIONS

Livestock producers usually specialize in particular kinds or breeds of animals or in certain phases of an animal's life cycle. This specialization may vary depending on geographic area, climate, topography, soil type, or the availability of water and feed, or on the producer's preferences, experience, or physical facilities. A producer may change his specialization from time to time based on recurring market cycles or more fundamental shifts in economic factors, such as consumer demand. Some producers are involved in more than one type of livestock operation at any given time.

The following is a brief discussion of the most common types of livestock operations, as well as the lending and loan analysis considerations for each.

Cattle

Beef Breeds

- *Cow-calf operation.* A producer has breeding stock that produces calves, which are then sold as either feeder calves or future breeding stock or are kept until the animal reaches full maturity.

  The typical cow-calf loan is for financing the breeding stock (cows and bulls) of a herd. The loan term is usually three to five years, with annual payments of principal and interest to fully amortize the loan within that term. Often, loans for this type of operation are written with one-year maturities and no predetermined amount of principal reduction at maturity. However, this kind of loan structure is more suitable for borrowers who are not highly leveraged.

  Repayment is from the annual sale of calves and cull cows (older cows or those that fail to produce offspring). Approximately 10 to 15 percent of a cow herd is culled each year; most cows are retained for seven to as many as twelve years. Bulls are typically stocked at one for each 20 to 25 cows; pregnancy rates are generally 80 to 100 percent, depending on the age and health of the cows and on feed availability.

Most calves are born in late winter and early spring, weighing around 100 pounds. Cows may be winter-fed on hay, but cows and calves graze on pastureland from spring to around October when the calves weigh 500 to 550 pounds. At this time, the calves may be sold to another producer who specializes in raising stockers. (However, in some areas, herds are managed to produce fall calves. Also, depending on feed sources and market conditions, calves may be sold at lighter weights, around 300 to 400 pounds.)

- *Stocker or backgrounding operation.* A producer in a stocker operation acquires calves weighing from 300 to 550 pounds and feeds them, primarily on pasture, until they weigh around 700 to 750 pounds, when they are sold to a finisher. Since the growth gains of young cattle are generally the most efficient phase of beef production, some stock operators prefer to buy lighter weight calves, although the lighter weights require more care and supervision to minimize death losses. Stocker operations are relatively high-risk programs that require specialized knowledge, but they can also be quite profitable.

  Backgrounding requires approximately 100 days, during which time the cattle may be fed a daily ration of silage (the entire corn or grain sorghum plant chopped into feed and stored in a silo) and grain and feed supplements, including soybean meal, minerals, salt, and vitamins. The supplements usually need to be purchased. Steers gain approximately two pounds per day, and heifers slightly less. Sometimes stocker cattle are placed on pasture, which can include dormant wheat in the winter or grass during the summer.

  Stocker cattle are typically financed with a 90- to 120-day single-advance, single-maturity note. Funds for feed purchases may be provided as part of the note proceeds, but, more commonly, the feed is raised by the producer. Loan repayment comes from the sale of the cattle when they weigh around 700 to 750 pounds. Collateral for stocker loans is typically the cattle financed and the feed. Banks usually require around a 30 percent margin in the cattle, but may require as little as 20 percent or less for financially strong borrowers.

  The profitability of a backgrounding operation is sensitive to the average daily weight gain, feed costs, weather, and purchase and sale prices of the cattle.

- *Finishing operation.* A finishing operation acquires cattle weighing approximately 700 to 750 pounds and feeds them a high-protein grain ration until they are ready for slaughter at around 1,100 to 1,200 pounds.

  Finishing usually takes around 130 to 145 days. Most finishing cattle are now custom-fed in commercial feedlots, but the producer (not the feedlot owner) usually retains ownership of the cattle. Feeder steers usually gain approximately 3.2 pounds per day, and heifers around 2.8 pounds per day. However, average daily gains vary depending on the breed, type of ration, time of year, or weather conditions.

  Finishing cattle can be risky because of fluctuations in cattle prices between purchase and sale dates. Some producers use futures contracts to lock in prices and reduce the risk, or they enter into forward contracts with a packer. Larger producers may use a "moving hedge" to offset the risk imposed by market cycles.[2]

  Banks normally require 20 to 30 percent initial margin in financing the purchase of feeder cattle, but may advance up to 100 percent of the feed costs. As the cattle gain weight, the bank's collateral position tends to improve. Repayment comes from sale of the cattle, with loan maturity set near the anticipated sale date.

Dairy Operations

Cows are milked for ten months each year, then rested for two months and allowed to "dry up" (quit producing milk by not being milked). Three months after a female dairy cow gives birth, she is rebred and calves nine months later. Cows are commonly bred through artificial insemination, which allows the producer to improve the genetics of the herd. Each year approximately one-third of the cows are culled,

2. In this strategy, the producer periodically buys a given number of lightweight feeders and at the same time sells a similar number of fat cattle. When prices are down, lower revenues from sales of cattle are offset by the benefit of lower costs to purchase replacement lightweight feeders. By the same token, when prices are up, higher purchase costs are offset by higher revenues on the slaughter cattle sold. This strategy allows the producer to prevent or substantially minimize losses due to fluctuating market prices. Otherwise, the producer might too often be in the position of only buying at high prices and only selling at low prices.

with replacement heifers usually raised on the farm. An 80 percent calf crop is common, with the males either sold soon after birth or fed for slaughter.

Milk production is measured by pounds of milk produced per cow per year. Production in the range of 13,500 to 20,500 pounds is common. Milk production variables include the quality of the cows, number of days milked each year, and amount and quality of feed. Feeding cows a higher ratio of grain to dry hay will result in higher milk production, but the higher feed costs must be weighed against the returns of higher production.

Feed is a major expense for a dairy operation. Dairy cows consume a ration of corn or grain sorghum, soybean meal, high-quality hay, silage, vitamins, and minerals. Family-oriented dairy operations usually grow most of their own feed on the farm, while larger operations purchase most of their feed and confine the cows to a dry-lot facility.

A dairy operation is heavily capital intensive because of the investment in cows, buildings, and equipment. Dairying is also labor intensive, which further adds to the cost of production.

The efficiency of a dairy operation is measured on a "per-cow" basis. Gross income, expenses, and net income can be divided by the number of cows to analyze trends and compare them with other dairy operations. Several other key indicators of a dairy operation's productivity include the following:

- *Pounds of milk per cow per year.* Herds averaging less than 14,000 pounds may be struggling.
- *Calving interval.* Twelve to thirteen months is favorable; if the interval lengthens, milk production and the overall efficiency of the operation will decline.
- *Calf losses.* A 10 percent or less loss on live calves born is favorable and considered an indication of good management.
- *Culling rate.* Cows should start milking when they are about two years old and should average four to five lactation periods before they are culled; if cows have to be culled prematurely, efficiency declines.

Loans to dairy operators may include longer-term financing for land and improvements; intermediate financing for the cow herd, specialized equipment, and vehicles; and operating loans to help finance the production of feed crops. Established operations may not require herd financing unless the herd is being expanded. Financing replacement cows to maintain a herd, if necessary, should be included in a shorter-term operating loan. Generally, operating loans are not a major financing activity as the dairy farmer's regular income from the sale of milk can often accommodate operating needs.

Collateral for dairy loans, in addition to real estate, typically includes the livestock, crops and feed on hand, and equipment. The collateral is usually covered with a blanket security agreement. Often, milk sale proceeds are assigned to the bank, and the milk buyer sends a monthly check directly to the bank to meet scheduled loan repayments.

Clearly, the primary source of income for the dairy farmer is the sale of milk, which is produced daily. Additional income is produced from the annual sale of calves and culled cows.

Hogs

Hog production consists of a two-stage operation: (1) "farrowing" (breeding sows to produce feeder pigs) and (2) "finishing" (fattening feeder pigs to slaughter weight). Many producers combine both enterprises and are called farrow-to-finish operations.

Hog producers range from small operators to large corporate interests. The small producers can be considered those who market less than 2,500 head per year; they can be involved either in finishing hogs or in farrow-to-finish operations. Small producers also tend to be involved in grain farming (raising their own feed) and other kinds of livestock production. The profitability and financial strength of a small producer is generally tied to the ability to market hogs frequently throughout the year, which lessens the impact of adverse market fluctuations. If the producer cannot market frequently, he or she probably needs to be involved in hedging practices. A corporate hog farm is usually a farrow-to-finish operation, with the number of sows ranging from 500 to as many as 100,000 for the largest producers.

Farrowing Operations

Hog breeding normally requires one boar for approximately 20 sows. Sows typically have two litters per year, and litter size is one of the most crucial factors in determining the success of a farrowing operation. Eight hogs per litter is a goal for most producers. Up to 25 percent of the sows will be culled each year. Some producers raise their own replacement sows, while others purchase quality breeding stock in an attempt to improve herd quality.

Pigs are farrowed (born) in confinement buildings, and after three weeks, they are moved to a nursery facility where the pigs are weaned from the sow. The capital invested in farrowing facilities varies greatly, but the trend has been toward higher investments in facilities that require less labor. However, a large investment in a single-use, costly hog facility can pose a significant risk if the farrowing operation is not profitable.

Feed costs are the largest operating expense of a farrowing operation. The feed required consists of a feed grain (corn or milo), a protein supplement, vitamins and minerals, and a pig starter (a commercial feed used in the transition from nursing to eating solid food). In a feeder pig production operation, the young pigs are typically kept until they weigh 40 to 60 pounds, which takes around two months. Feed costs are continually changing because of fluctuating grain prices, so it may be difficult to project cash flow accurately. Historical cash flow may be more useful in demonstrating the borrower's overall management capabilities.

Loans to farrowing operations may include an intermediate- to mid-term loan on the facilities (usually not for more than ten years), breeding stock loans that should be amortized over no more than four years, and operating loans. Operating loans are often in the form of revolving lines of credit to purchase feed, with repayment normally coming from the sale of hogs. The operating line should be cleaned up periodically, or the bank should establish systems to monitor advances and repayments to ensure that stale debt is not accumulating.

Collateral for a farrowing operation could include the facilities and the hogs and feed on hand. For collateral purposes, the hogs should be valued at local market prices even though the producer might have paid a premium for breeding stock. Feed should be heavily margined, as the proceeds from feed sale during a foreclosure are likely to be limited.

Loan repayment comes primarily from the sale of young feeder pigs and culled sows. The timing of scheduled repayments will vary, depending largely on the producer's breeding schedule and the anticipated sale dates for feeder pigs. Usually, sows are bred at different times so they are not all having pigs at the same time. In the case of a farrow-to-finish operation, the cycle will be longer, and repayments will be scheduled according to anticipated sale dates of the fat hogs and culled breeding stock.

Finishing Operations

Hog finishing is the process of acquiring young pigs that weigh 40 to 60 pounds, and feeding them until they reach a slaughter market weight of 220 to 240 pounds. The process takes approximately four months. The average death loss for a finishing operation is generally 4 to 5 percent of the total number of hogs started on feed.

Loans for hog finishing are usually in the form of single-payment notes that mature in approximately four months. Loan proceeds are used to purchase young pigs and may also be used to purchase feed. A bank commonly advances up to 100 percent of the purchase price of the pigs. Usually, there is a blanket security agreement in place that gives the bank a security interest in all hogs, as well as in feed and other chattels to provide additional overall support for the credit. Margin in the collateral increases as the animals gain weight. Repayment comes from the sale of fat hogs to a packing plant.

The main factors in determining a finisher's profitability are (1) the cost of the feeder pigs, (2) the cost of feeding the pigs, and (3) revenues from the sale of hogs. Costs and revenues continually change because of fluctuations in market prices for young pigs, slaughter hogs, grain, and feed. Because of the relatively short cycle of hog finishing, a number of loans may be made during one year. In analyzing hog loans, reviewing the overall profitability of the operation (taking into account depreciation on facilities and equipment, interest, and insurance) is more meaningful than reviewing the results from each individual loan advance.

Sheep

Sheep are raised for the production of meat and wool. The most common sheep enterprise is the raising of ewe (female) flocks, which produces income from the sale of both wool and lambs. Larger flocks tend to be more efficient as they can take better advantage of investments in labor-saving equipment.

Ewes give birth once a year, usually during late fall or winter. They frequently have twins, resulting in an overall lamb production per ewe of approximately 140 percent. About 20 percent of the ewes are culled each year, with replacements usually being raised from lambs. There is typically one ram for each 30 ewes in a breeding flock. The sheep and lambs graze on pasture during the summer and are fed a ration of roughage and grain during the winter.

Loans to ewe flock operators are made to purchase breeding stock and to pay operating expenses. Breeding-stock loans should be amortized over no more than five years. Repayment comes primarily from the sale of lambs and wool.

Typically, lambs are finished in commercial feedlots until they reach slaughter weight, which involves purchasing 60-pound feeder lambs and feeding them a hay-grain ration for about 90 days until they weigh approximately 120 pounds. The loan term is usually 90 to 120 days, with the sale of fat lambs to a processor being the source of repayment. Collateral consists of the lambs, which should be valued at local market prices. Margin required in the lambs, if any, will depend on feedstocks owned or on the borrower's financial strength.

Poultry

Poultry production has become a very large and highly organized agribusiness. Large corporate producers dominate the industry. However, they depend to a large extent on individual growers, with whom they contract to raise the birds almost from the day they are hatched until they are ready for slaughter. The large company supplies an independent grower with the day-old chicks, feed, and medications and provides technical support. Under the contract, the company pays the grower at a rate designed to provide an acceptable return on the grower's investment in poultry houses, equipment, and labor.

Producing breeding stock, incubating eggs, hatching chicks, and producing pullets and eggs are other aspects of the poultry industry that are highly specialized and relatively concentrated within fairly large corporate producers. Most banks will not extend loans on these types of operations, and any that do should have substantial background information on the industry in their files. The examiner should review that information and discuss the industry and the borrower's operation with the officer originating or servicing the credit.

The typical grower owns 60 to 80 acres of land and has an average of three to four poultry houses. Most growers also have other jobs and earn supplemental income from their growing operations. Broiler (or fryer) chickens generally are grown to a live market weight of approximately 4.2 pounds at 42 days of age.

Most bank loans to contract poultry growers consist of construction loans to build poultry houses and permanent financing for the houses and equipment. The houses are large but of relatively simple construction. Permanent financing is typically amortized over 10 to 15 years.

Government guarantees (Farmers Home Administration, Small Business Administration, or various state agencies) are often available to mitigate the bank's risk by guaranteeing from 85 percent to as much as 100 percent of the permanent loan. Federal guarantees have not been available for construction financing of poultry houses, so the bank generally will have to assume the full risk of the loan during the construction period.

Construction loans are generally converted into long-term loans that are repaid with the contract income a grower receives from the large corporate producer. Since feed and other supplies are typically furnished by the large producer, individual growers do not normally require operating loans.

Egg production for consumption (rather than hatching) is another aspect of the poultry industry; it is also highly organized and controlled by large producers. Facilities, feed, and labor represent the primary costs for these operations, with repayment coming primarily from the sale of eggs. Some income is also derived from the sale of "spent" hens (older hens that are no longer efficient layers). These operations are capital intensive and highly specialized. Loans to egg producers need to be carefully analyzed to determine whether they are properly structured and adequately margined. Assessment of the borrower's overall management ability, and record of profitability, industry trends, and any special risk factors is particularly important in judging loan quality.

OPERATING (PRODUCTION) LOANS

Banks (and other lenders) commonly finance the operating expenses of agricultural producers with short-term operating loans. Expenses financed may include items such as cash rent; seed; fertilizer; chemicals; irrigation; fuel; taxes; hired labor; professional fees; and, for a livestock producer, feed, feed supplements, veterinary care and medicines, and other supplies. Operating loans may take the form of single-purpose financing or line-of-credit financing. The single-purpose loan is the simplest and most basic form of financing, as it does not attempt to address the borrower's total credit requirements, and the repayment source and timing are relatively certain.

Line-of-credit financing may accommodate most of a borrower's operating needs for the production cycle. Advances are made as needed to purchase inputs or pay various expenses, with all income usually remitted to the lender to reduce the line. Depending on the type of operation, the line may seldom be fully retired because funds are advanced for a new operating year before all inventories from prior years are marketed. An operating line of credit is generally established after cash-flow projections for the year are made to anticipate credit needs and repayment capacity. While this type of financing has the advantages of convenience and accurate cash-flow monitoring (which permits comparing actual cash flow with projections), it can also have some disadvantages. The lender may be inadvertently funding or subsidizing other creditors' payments with advances on the line and, because operating cycles overlap, it may be difficult for the lender to get out of an undesirable situation.

An operating line may be revolving or nonrevolving. A revolving line replenishes itself as repayments are made, so the outstanding balance can fluctuate up and down during the approved term. There is no limit on the total amount borrowed during the term of the line, as long as the amount outstanding never exceeds the established limit. A nonrevolving line is structured so that once the approved amount is used, even though payments are made to reduce the line, the borrower must reapply and receive approval for any further advances. Revolving lines afford flexibility but have no firm disbursement or repayment plan, so they are usually reserved for borrowers with strong financial positions, proven financial management, and a history of cooperation and performance. Bank management should continually monitor operating lines and clearly document the purpose for advances and source of repayments. A clean-up period may or may not be required after harvest or completion of the operating cycle, depending on the anticipated schedule for selling farm or ranch production.

The primary source of repayment for an agricultural operating loan is revenue from agricultural production. Many farmers also receive some form of government support payments, and they may have employment off the farm or do custom work (such as harvesting) for hire. In many cases, wages or salaries generated from the nonfarm employment of a farmer's spouse will cover a significant portion of the family's living expenses, relieving the financial pressure on the farming operation. To evaluate repayment capacity, the loan officer must determine how much revenue will be generated from either current production or inventories. Revenues will need to be sufficient to cover all expenses, however, not just those funded by the loan. These could include various operating expenses, family living expenses, payments on capital debt (for real estate and equipment), and any anticipated new capital expenditures. There should also be a margin to cover incorrect assumptions about yields and prices.

Most agricultural lenders recognize the need for yearly cash-flow projections to help determine credit needs and repayment capacity. Projections of both income and expense are usually made for each month (or each quarter) of the year to anticipate the amount and timing of peak financing needs, as well as the total net cash flow for the year. Obtaining and analyzing yearly federal income tax returns (particularly Schedule F) should be strongly encouraged as a means of reviewing actual operating results. Actual data can then be compared with projections to determine variances. Reasons for the variances should be understood as a part of the credit analysis process. This analysis will help the bank decide whether to grant or deny credit and service loans.

If a borrower loses money from operations in one year and cannot fully repay the operating loan, there will be "carryover debt." In general, carryover debt should be segregated, secured with additional collateral if possible, and amortized over a reasonable term that is consistent with the borrower's repayment capacity. Consistent losses and excessive carryover debt can preclude further advances and lead to the sale of certain assets or even to full liquidation of the operation.

Collateral for a typical operating loan includes growing crops, feed and grain, livestock, and other inventories. Normally, a bank also obtains a security interest in equipment, vehicles, government payments, and other receivables to strengthen the collateral margin. For new borrowers, a lien search is recommended to determine the presence of any senior liens. Pledged assets should be valued, either by a knowledgeable bank officer or an outside appraiser, and the operation and collateral should be inspected periodically to judge conditions and values. Inspections for established borrowers are usually done at least annually. More frequent inspections are usually performed on marginal borrowers or if the borrower has a feeder livestock operation with more rapid turnover of assets.

GOVERNMENT AGRICULTURAL SUBSIDY PROGRAMS

Federal government programs have long been able to help farmers financially and, to an extent, control the overproduction of agricultural products. These programs are continually evolving, but remain important in determining many producers' income levels and profitability. In addition to establishing subsidies, the programs also set limits on the number of acres of certain crops that a producer can plant to help control crop surpluses and support price levels.

Conservation Reserve Program

The Conservation Reserve Program (CRP) is a long-term retirement program for erodible land. Landowners submit bids for a 10-year contract, stating the annual payment per acre they would accept to convert the highly erodible land to a grass cover. The maximum bid per acre has been established, and accepted bids must not exceed prevailing local rental rates for comparable land. If the bid is accepted by the local Agricultural Stabilization and Conservation Service (ASCS) office, the landowner must sow the land to grass, with the cost of planting grass shared by the landowner and the government.

During the term of the 10-year contract, the landowner cannot plant a crop on the land, allow grazing on it, or cut the grass for hay. The CRP contract is assignable, so it can be transferred to a new owner along with title to the land.

Farmers Home Administration

The Farmers Home Administration (FmHA) is a federal lending agency operating within the U.S. Department of Agriculture. The FmHA performs two main functions: (1) providing supervised credit to farmers who are unable to obtain adequate credit from commercial banks and (2) improving rural communities and enhancing rural development.

Three basic programs allow the FmHA to extend funds to farmers: (1) grants, (2) direct loans, and (3) loan guarantees. The grant program is the smallest and generally relates to rural housing and community programs, most of which are for water and waste disposal systems. The direct loan programs are for loans made by FmHA through its county and state offices to farmers. The loan guarantee program permits the FmHA to guarantee up to 90 percent of the amount of loss on a loan made and serviced by another lender.

Most FmHA loans are (1) farm-operating loans, (2) farm ownership loans, or (3) emergency farm loans. Operating loans and farm ownership loans are for operators of family farms. Eligible purposes for operating loans include capital loans for machinery and livestock, as well as annual production inputs. Farm ownership loans are available for buying land, refinancing debts, and constructing buildings. Emergency loans are designed for farmers in counties where severe production losses have resulted from a disaster or from economic emergencies.

To qualify for a loan, a borrower must (1) be unable to obtain sufficient credit elsewhere at reasonable rates and terms, (2) be a citizen of the United States, (3) be an owner or tenant operator of a farm not larger than a family farm, and (4) have sufficient training or experience to ensure a reasonable chance of success in the proposed operation.

Banks have been highly motivated to use the FmHA-guaranteed loan program as a means of mitigating risk and perhaps developing a sound customer for the future. An FmHA loan also improves the bank's liquidity, since the guaranteed portion of the loan can be sold in the secondary market.

Small Business Administration

While it is not primarily a lender to agricultural producers, the Small Business Administration (SBA) has made low-interest-rate disaster loans available to individuals, including farmers. The SBA can make or guarantee various types of agricultural loans to producers whose annual revenues do not exceed $500,000. Banks occasionally make these loans, which are supported by collateral as well as a substantial percentage guarantee by the SBA. In many rural areas, however, it is probably more convenient for a bank to work with a nearby FmHA office than with an SBA office, which may be located some distance away in a metropolitan community.

Federal Crop Insurance Corporation

The Federal Crop Insurance Corporation, which is a part of the U.S. Department of Agriculture, writes multiperil crop insurance. The premiums for this insurance are subsidized by the federal government. For further information, see the following subsection on crop insurance.

CROP INSURANCE

The Federal Crop Insurance Reform Act of 1994 combined crop insurance and disaster aid into a single, unified program. To be eligible for any price support or production adjustment program and for new contracts in the conservation reserve program or any FmHA loan, farmers must carry crop insruance coverage. The expanded crop insurance program replaces the need for disaster bills as the federal response to emergencies involving widespread crop loss.

Aside from the basic required coverage under the federal program, known as the catastrophic coverage level, banks encourage some borrowers to carry crop insurance to reduce their risk of not being repaid on farm-operating loans. Borrowers that are more highly leveraged and have minimum margin in their operating loans are most likely to be required to carry crop insurance. Two common types of crop insurance are (1) crop hail insurance sold by private insurers, which insures only against hail damage, and (2) multiperil crop insurance written by the Federal Crop Insurance Corporation. As its name implies, multiperil crop insurance insures against drought, rain, hail, fire, wind, frost, winterkill, disease, and insect losses.

The federal government subsidizes the multiperil crop insurance premium by paying most of its administrative, actuarial, underwriting, and selling expenses. By subsidizing premiums and encouraging more producers to purchase the insurance, the government hopes to reduce the dependency on crop disaster payments when natural disasters occur. However, this program has not been particularly popular with farmers because they would have to suffer a high level of losses on all planted acres to receive any significant proceeds from the insurance. By diversifying their crops and planting in fields that are separated by significant distances, many farmers are willing to risk planting without crop insurance.

EVALUATING AGRICULTURAL MANAGEMENT

A crucial factor in loan analysis for banks, as well as for examiners, is an evaluation of the management capabilities of the agricultural producer. Cash earnings from an operation provide the primary source of repayment for most agricultural loans, so it is important to evaluate the borrower's ability to manage a profitable operation. The three kinds of management that agricultural lenders most often analyze are production, marketing, and financial management.

Production Management

A lender should first assess the borrower's technical ability as a producer of crops or livestock. This is primarily an objective measure because it consists of comparing an operation's output against industry and area norms. An operator whose production levels are consistently below average will probably have difficulty meeting debt-service requirements and may not be able to stay in business. There may be justifiable reasons for occasional years of below-average production, but lenders should be cautious of operators who consistently perform poorly.

Another factor to consider is the producer's ability to successfully cope with the inherent variability of agricultural production. Adverse weather, disease, and pest infestations are all production risks that continually affect crops and livestock. Some producers diversify the commodities they produce to reduce their dependency on one crop or type of livestock.

Marketing Management

Good marketing management enables the producer to reduce price risk exposure. Volatile markets have convinced most producers and lenders that sound marketing is crucial for an ongoing agricultural operation, and almost every producer needs a marketing plan designed to control price risk. Aside from helping to ensure profitability, the plan can be incorporated in formulating a more reliable statement of projected cash flow, which helps both the lender and producer anticipate financing needs.

Some of the techniques that producers use to manage price risk exposure are forward contracting, hedging, purchasing options, and using government programs. See the subsection "Marketing Farm Products" for details.

Financial Management

A producer should have the ability and willingness to understand, maintain, and use financial records. The importance of sound financial records began to be more fully appreciated in the 1980s when agricultural loan losses rose, and many agricultural producers and banks failed. During that time, the primary emphasis for many agricultural lenders shifted from collateral-based lending to cash-flow lending. While collateral may afford ultimate protection for the lender under a liquidation scenario, cash flow allows for repayment of debt in the normal course of business.

In addition to recordkeeping, financial management also encompasses how a producer uses his or her assets and liabilities. Maintaining financial reserves in the form of current assets is one means by which a producer can be prepared to overcome short-run adversity. The reserves need not necessarily be cash; they might be in the form of stored grain or other nonperishable produce or they could be earning assets such as livestock, which is readily marketable. Controlled, reasonable equipment purchases are another indication of good financial management. Overspending on equipment may be indicated if the borrower's equipment list includes many items that are new, especially costly, duplicative, or unneeded for the types of operations being conducted. The presence of sizable nonbank equipment debt on the borrower's financial statement can, in some cases, also reflect overspending.

MARKETING FARM PRODUCTS

Marketing considerations have become more important for many producers as they attempt to maximize returns. Rather than merely selling crops or livestock at prevailing market prices when the production cycle is complete, some producers attempt to lock in a price through the use of forward contracts or futures or options trading. Some producers of nonperishables may simply study market action and cycles and keep harvested crops in storage, waiting for higher prices. Some livestock producers may buy and sell throughout the year to help even out the effects of market fluctuations. Both the bank lending officer and the borrower need to have a clear understanding of the marketing plan, including its potential costs, benefits, and risks.

The following comments briefly describe some of the basic tools producers use as alternatives to the cash market to manage price risk.

- *Forward contracting*. The producer contracts with a buyer to sell farm products at a fixed price in advance of the actual marketing date. These contracts are simple to use if willing buyers can be found, but carry some risk of the buyer's defaulting, particularly if market prices decline significantly before the contract matures. This risk may be mitigated to some extent by requiring the buyer to provide security in the form of a 10 to 15 percent margin to help ensure that the buyer honors the contract.
- *Minimum-price forward contract*. This is a relatively new type of forward pricing that may be available to some producers. It establishes a floor but not a ceiling for the price the producer will receive for his commodities, so it protects against price declines but permits the producer to garner additional profits if the

market rises.

- *Basis contracting*. This is a variation on forward contracting, whereby the price the producer receives is not fixed when the contract is drawn, but will be determined by the futures market price plus or minus some agreed-on difference (basis). For example, cattle for September delivery might be priced at the September futures price (as of a date to be selected by the seller) plus 50 cents per hundredweight. Accordingly, a basis contract does not reduce risk until the price is set by the seller, so if the seller waits to set the price, he or she is still subject to all market risk. However, a basis contract can be combined with a put option (see below) to set a minimum price.
- *Hedging*. Hedging involves the use of counterbalancing transactions to substantially eliminate market risk. The type of hedge typically used by an agricultural producer is sometimes referred to as a "short hedge" because it involves use of the futures market to, in effect, sell short. Later, when the producer's commodities are ready for delivery, he sells them in the cash market. If the price has declined, he makes a profit on the sale of the futures contract to offset the lower price he receives in the cash market. Conversely, if the price has increased, a loss on the futures contract will be incurred to offset the gain in the cash market. Hedging is similar to fixing a price with a forward contract except that the price is said to be an "expected" fixed price, since the difference between the cash and futures prices may not be correctly anticipated and the resulting net price received will vary some from the expected level. Hedging can have an advantage over forward contracting because it is readily available and based on competitively determined futures prices. Since positions in the futures market require the producer to keep a cash margin with the broker, and additional margin calls may have to be met if the market goes up (after the producer has sold short), it is especially important that the bank loan officer be aware of and understand the borrower's marketing plan.
- *Put option*. Buying a put option gives the producer the right, but not the obligation, to sell a commodity at a given (strike) price any time before the put's expiration date. It protects against falling prices because the put becomes more valuable as prices fall. At the same time, a put allows the producer to benefit from rising prices, if they rise more than enough to cover the cost of the put. Puts can also be attractive because they can limit losses by establishing a minimum price at times when current prices are not profitable and the producer is reluctant to fix a low price with forward contracting or short hedging. Puts have the disadvantage of being more expensive than hedging; premiums for put options can be especially high when market prices are high.

Other more complex strategies are sometimes used that combine cash and futures instruments to minimize risk or to modify initial positions to adjust for changing market conditions, including the following.

- *Establishing minimum prices with basis contracts*. Purchasing a put option along with selling commodities on a basis contract establishes a minimum price, while allowing the producer to gain from rising prices.
- *Converting a fixed price into a minimum price*. If a producer accepts a fixed price via forward contracting and later regrets that decision, he or she may decide to purchase a call option (which becomes more valuable as prices rise). The combination of a fixed-price contract and a call option is called a "synthetic put" because the net effect is the same as buying a put option. The producer who has accepted an estimated fixed price via a short hedge can either lift the hedge (cover the open short sale in the futures market) or, depending on circumstances and relative costs, leave the hedge in place and purchase a call option.
- *Converting a minimum price into a fixed price*. If a put option has been used to set a minimum price at very low levels, and prices subsequently increase, the producer can either roll up the put to a higher strike price or sell futures and establish a fixed price when the market reaches an acceptable level. Buying one or a series of additional puts allows the producer to profit from a further rising market but may become expensive.

FINANCIAL AND INCOME INFORMATION FOR AGRICULTURAL PRODUCERS

The financial and income information most commonly used by agricultural lenders includes balance sheets, income tax returns, and statements of projected cash flow. Many producers do not prepare income statements on an accrual basis. Often, their only available income statement is Schedule F of the annual federal income tax return.

Balance Sheet

Balance sheets for agricultural producers usually divide assets and liabilities into three groups—current, intermediate, and long-term—based on the liquidity of assets and repayment schedules of liabilities. Current assets are those that will either be depleted within 12 months or can easily be converted to cash without affecting the ongoing business operation. Current assets include cash, accounts receivable, livestock held for sale, inventories of crops, feed, supplies, growing crops to be harvested within 12 months, and prepaid expenses.

Intermediate assets support production and may be held for several years. Principal intermediate assets include breeding stock, equipment, and vehicles. While these assets may be relatively liquid, their sale would seriously affect the productivity of the operation.

Long-term, or fixed, assets are more permanent in nature and benefit the operation on an ongoing basis. The principal fixed asset of an agricultural operation is farm real estate, although the producer may have other long-term assets, such as investments, which may or may not be related to his or her farming or ranching operation.

Current liabilities include those which must be paid within 12 months, including amounts owed for feed, seed, supplies, interest, and taxes. The amounts of any payments due within 12 months on intermediate-term and long-term debt should also be included in current liabilities.

Intermediate liabilities are generally those due between one and ten years from the statement date, and commonly represent debt to finance equipment and vehicles. As mentioned above, the amounts of payments due on these debts within 12 months are shown as current liabilities.

Long-term liabilities usually are those that, at inception, had a maturity of more than ten years. Debt on real estate is the main type of long-term liability on the balance sheets of most agricultural producers.

The difference between total assets and total liabilities is the net worth of the producer or the equity in the producer's assets. Most producers are individual or family farmers whose balance sheets also include personal assets not directly used in the operation, as well as debts owed on those items.

It is important to remember that the amount shown on the statement for net worth is subject to question. Since it is merely the difference between the amounts shown for total assets and total liabilities, its accuracy depends on how the assets are valued and whether all liabilities are reflected. Most agricultural borrowers value assets on their balance sheets at what they assume to be "market value." However, some tend to use rather optimistic valuations, particularly on items such as equipment and real estate. Also, some borrowers tend to carry the same values forward each year for real estate or equipment, which may cast some doubt on accuracy. Examiners reviewing agricultural credits should try to determine prevailing market prices for various types of land in the bank's trade area and acquire general knowledge of equipment values. Recent published sales data on both real estate and equipment provide reliable indications of current values.

Sometimes not all liabilities are fully or properly disclosed. A form of potential liability that is often not disclosed is the amount of deferred income tax that will be due on the sale of real estate in which the borrower may have a substantial unrealized capital gain. It may not be possible to readily estimate such deferred-tax liability unless the borrower's statement shows both cost and market values. However, the examiner should keep these points in mind in analyzing the balance sheet, in an attempt to accurately assess the borrower's financial strength. Comparison with previous balance sheets, other information in the loan file, and general knowledge about values will aid the examiner in this analysis.

It is advisable to determine how the balance sheet was prepared and by whom. Many are prepared by the borrower and submitted to the bank. Others may be prepared by the borrower and lending officer working together. Presumably, the latter method would tend to ensure a more accurate presentation but, if not, it could raise questions about lending practices or the lending officer's competency. Similarly, balance sheets that do not balance (not an unusual occurrence) might indicate a lack of appropriate analysis by the lending officer.

Balance-Sheet Ratio Analysis

The following are some basic, fairly simple ratios that can indicate the financial strength of a producer.

- *Current ratio (current assets/current liabilities).* This ratio can reflect a borrower's ability to meet current obligations without additional borrowing.
- *Quick ratio (liquid assets/current liabilities).* This ratio compares current assets that are easily converted into cash with current obligations and reflects a borrower's ability to immediately meet current obligations.
- *Leverage ratio (total liabilities/net worth).* This ratio shows the relationship between borrowed capital and owned capital. The higher the ratio, the greater is the reliance on borrowed capital, which means higher interest expense, potentially lower net income, and certainly less equity cushion to withstand risk and adversity. This is often called the *debt-to-worth ratio*.

Ratio Interpretation Guidelines[3]

Ratio	*Low Risk*	*Moderate Risk*	*High Risk*
Current Ratio	1.5:1	1:1–1.5:1	<1:1
Quick Ratio	1.1:1	.8:1–.5:1	<.5:1
Leverage Ratio	.75:1	1:1	1.25:1

Income Statement

Determining actual profitability for most agricultural borrowers is difficult, primarily because of the absence of complete income and expense information on an accrual basis. The most common income statement for agricultural producers is Schedule F of the federal income tax return (“Profit or Loss from Farming”), which accompanies Form 1040. It is prepared on a cash basis, showing cash income received and cash expenses paid, although the taxpayer is also permitted to deduct depreciation expense for items such as equipment, improvements to real estate, and breeding stock. Farmers may have other farm-related income reported on Form 4797, which reports sales of dairy and breeding livestock, or on Schedule D, which shows sales of real estate and equipment. Additional nonfarm income is reported on page 1 of Form 1040. All sources of income need to be considered by lenders and examiners, but for most farm borrowers, Schedule F is the primary report of income for the farming operation.

Tax returns probably provide the most accurate income and expense information for most farm operations. Some lenders attempt to convert the cash basis Schedule F to an accrual basis by adjusting for changes in inventory values, receivables, payables, and similar items, but the process requires timely, detailed financial information that often is not readily available. Instead, many lenders and examiners look at cash-basis income over a three-to-five year period to analyze trends and even out the cash-flow variances caused by differences in production and marketing cycles.

While cash income is not necessarily a good measure of farm business profits, it does help show the cash-flow situation and is useful in planning debt repayment programs and family budgets. In addition, cash income statements can be compared with projected cash flows to determine variances that need explanation or that may indicate the need for changes in the operation.

Operating Ratio Analysis

Key ratios can be calculated from income statements to aid in analysis. The most commonly used ratios measure profitability, repayment ability, and efficiency. Profitability is usually determined by return on equity and return on assets. Repayment ability can be determined by the earnings coverage ratio and debt payment ratio. The most common economic efficiency ratio used is the operating expense to revenue ratio. Although many smaller banks have not used income statements to any extent to analyze agricultural credits, this type of analysis can provide useful insights into an operator's efficiency and repayment ability.

3. These ratio interpretation guidelines are only rules of thumb and need to be viewed in conjunction with a thorough analysis of other pertinent factors, including balance-sheet composition, the nature of the operation, and an assessment of the borrower's management ability.

Return on assets is usually calculated by adding interest expense to net farm income and deducting a management fee (usually an amount for unpaid family labor), then dividing the resulting figure by average total farm assets for the year. Return on equity is usually calculated by deducting a management fee or unpaid family labor from net farm income and dividing the difference by total farm net worth.

Common ratios used to assess debt repayment ability and repayment risk are the earnings coverage ratio and the debt payment ratio. The earnings coverage ratio (also known as the cash-flow ratio) is a measure used to assess the operation's ability to repay. A strong earnings coverage ratio would be 30 percent or above. An acceptable but riskier level would be 10 to 30 percent. The debt payment ratio is used to determine risk over the term of the loan. It is calculated by dividing total annual debt payments by total revenue. As a general rule, total principal and interest payments should not exceed 25 percent of total revenue. A ratio of less than 15 percent would be relatively safe, while a 15 to 25 percent range would indicate some degree of risk.

The operating expense to revenue ratio measures the operating efficiency of the farm exclusive of debt obligations. A ratio of less than 70 percent usually reflects an efficient manager who can service larger amounts of debt. If the ratio exceeds 80 percent, repayment problems could occur if large amounts of debt are outstanding. The ratio tends to be higher for smaller operations.

The following example shows how the earnings coverage, debt payment, and operating expense to revenue ratios are determined from the income statement. This example reflects generally adequate ratios.

1. Total farm revenue	$210,000
2. PLUS: Nonfarm revenue	22,000
3. Total revenue (line 1 + line 2)	232,000
4. LESS: Farm operating expenses (excluding interest and depreciation)	153,000
5. LESS: Family living expenses and income taxes	35,000
6. Earnings available for interest and principal payments and new investments	44,000
7. LESS: Interest and principal payments	32,500
8. Remaining earnings available for risk, uncertainty, or new investments	11,500

Earnings coverage ratio = line 8 divided by line 7	35%
Debt payment ratio = line 7 divided by line 3	14%
Operating expense to revenue ratio = line 4 divided by line 1	73%

Statement of Projected Cash Flow

Projecting cash flow for an agricultural operation gives recognition to the importance of cash flow in servicing the debt of an ongoing operation. It also tends to impose some discipline on both borrower and lender by requiring a thoughtful planning process for the year in terms of anticipated income, expenses, financing needs, debt-servicing requirements, and capital expenditures. For individual or family farm operations, family living expenses should be included in the projections, as well as nonfarm income.

A cash-flow statement typically shows both the timing and amount of cash receipts and expenses. It can be either a forecasting device (statement of projected cash flow) or historical record (statement of actual cash flow). Banks and other lenders most commonly use the statement of projected cash flow because it aids in planning the borrower's credit needs, usually for the coming 12-month period.

A statement of projected cash flow shows not only how much credit is likely to be needed, but approximately when it will be needed. Perhaps most importantly, it shows whether cash income is expected to exceed expenses for the year. It also indicates the likely high point of the credit (amount and time) and the expected cash or debt position at the end of the year. The projected cash-flow statement represents a kind of budget that provides benchmarks against which actual performance can be compared. Significant variances call for explanations and may prompt certain actions to improve future operating results. Historical statements of actual cash flow have value for comparative purposes and can be an excellent aid in preparing projections for the following year, although banks do not typically request them from most agricultural borrowers. They tend to rely, instead, on income tax returns for information on actual operating results.

Cash flow projections are usually made near the beginning of a calendar year, although timing can vary depending on the nature of the operation. The statement is prepared as a spreadsheet normally listing, by month, anticipated cash receipts and disbursements. For each period, the projected operating-loan balance is shown after adjusting for the amount of projected net cash flow.

AGRICULTURAL LOAN POLICIES

Not all banks make agricultural loans, but for many banks, these loans comprise a significant portion of their portfolios. Any bank making agricultural loans should have developed an adequate, formalized set of written policies to guide the lending officers and staff. Agricultural loan policies should address the same general considerations as the policies used for other loan categories, such as desirable, undesirable, or prohibited loans; collateral requirements (including evaluation guidelines); maximum loan-to-value ratios; maximum maturities; documentation requirements; and concentration limitations. Given the specialized nature of agricultural assets and the varied types of operations, the policies should be comprehensive and specifically address the types of agricultural loans the bank intends to make.

Some banks may have general policies, supplemented by separate procedures or practices. Regardless of the individual bank's terminology or the way in which the material is organized, it is important that the bank's board of directors ensure that appropriate written guidance is provided for management in the agricultural lending area. The policies should help ensure that loans are made on a sound basis and provide a framework for identifying, addressing, and resolving problems that arise. Loan grading, either by the loan officers, a separate loan review function, or both is desirable, as well as a general plan for actions to be taken on loans with unsatisfactory grades. The policies should also address collection and charge-off considerations. Agricultural loan policies should be reviewed by the bank's board of directors and modified when deemed necessary. For more detailed guidance on bank loan policy, refer to section 2040.1, "Loan Portfolio Management."

AGRICULTURAL LOAN DOCUMENTATION

Loan documentation establishes the bank's legal position as creditor and secured party and evidences the borrower's ownership of and actual existence of collateral. Some documents, such as an insurance policy, give some evidence of collateral values and ensure that tangible collateral is protected. A number of documents play a supporting role, as they provide information that is vital in assessing a borrower s creditworthiness and in demonstrating the borrower's financial capacity to regulatory authorities, auditors, loan reviewers, senior management, and the board of directors. The documents also help management to service and grade the credit, determine the nature and extent of any problems, and formulate plans to resolve them by strengthening the bank's position or averting losses.

Absence of complete and current loan documentation is a weakness in the lending function and can pose a significant threat to the bank's safety and soundness. Some documentation exceptions are noted during virtually every examination, largely due to inadvertent oversights or unavoidable delays in obtaining original or updated documents. However, an unusually large volume of exceptions can be an important indication of weak and deteriorating loan quality. Excessive exceptions reflect unfavorably on management and indicate a need for management to either formulate stronger loan policies and procedures or to emphasize adherence to established guidance.

Many banks use a standard checklist to help ensure that all applicable documents are obtained when a loan is made. Most banks also have either an automated or manual "tickler" system to identify when updated documents are needed, such as current financial statements, tax returns, UCC-1 filings, collateral inspections, and evidence of insurance. Because of the large volume of required documents, many of which need to be updated at least annually, it is imperative that bank management be firmly committed to a sound loan documentation program. The program should establish responsibility for obtaining documents, monitoring compliance, and providing follow-up to help ensure that all required documents are obtained in a timely manner.

Not every document is applicable to each agricultural loan. Examiners need to assess which documents are appropriate for a given loan depending on its individual circumstances. There should be little disagreement between examiners and bank management about the basic documents needed. Basic documentation requirements are usually listed in the bank's loan policies or procedures. The need for certain supporting documents may be a matter of judgment, particularly in regard to frequency of updating documents. In most cases, however, bankers and examiners tend to agree on items that are to be considered documentation exceptions. Refer to section 2080.1, "Commercial and Industrial Loans," for further guidance on loan documentation. Following is a list of the types of documents a bank should have in connection with agricultural loans:

- promissory note
- security agreement
- financing statement
- real estate mortgage or deed of trust
- other collateral assignments, as appropriate (such as assignments of third-party notes, mortgages or deeds of trust, life insurance policies, deposit accounts, securities, or other contracts)
- subordination agreements (for example, a prior lienholder may subordinate its lien position to a bank to induce the bank to make a loan)
- appraisals
- hazard insurance policy or certificate of coverage
- cash-flow projections, usually prepared annually
- income tax returns
- financial statements (balance sheets) for the borrower, cosigner, or guarantor
- collateral inspection reports by the bank
- bill of sale for livestock or equipment
- worksheet for each note (showing the purpose, timing, and source of repayment; collateral; total existing bank debt; analysis)
- overall credit analysis (particularly on large or troubled loans)
- loan officer memos and comments
- correspondence

LOAN ADMINISTRATION AND SERVICING

In addition to making agricultural loans, analyzing creditworthiness, setting loan terms, obtaining collateral, and assembling required documentation, management needs to administer the portfolio of outstanding loans. They need to monitor borrowers' performance relative to agreed-upon terms, collateral margins, financial and income data, cash flow, crop prospects, and market trends that may affect borrower performance. If problems arise, bankers need to formulate and implement plans to protect the bank's position.

Farm and Livestock Inspections

A physical inspection of the farming operation is usually performed by bank management before advancing any substantial funds to a new borrower. Subsequent inspections, particularly for larger or more marginal borrowers and for readily moveable collateral, should be performed periodically. Inspections may be performed by the loan officer or by another bank officer or employee with agricultural experience. The inspector usually prepares a fairly detailed report listing farm assets (livestock, equipment, grain and feed on hand, and growing crops) and at least brief comments on the condition of assets and crop prospects. Often, a listing of machinery, equipment, and vehicles is prepared from the bank's records ahead of time to aid in the inspection process; any additions, deletions, or exceptions noted should be shown on the report. Livestock are listed by type, showing numbers, sex, and approximate weight. Values for all items should be shown on the report, based on current market prices. The report may note the number of acres the potential borrower owns and rents, as well as the approximate value of real estate owned. A real estate evaluation might be performed as part of a farm inspection, but a full appraisal, if required, would almost always be performed separately, usually by another individual.

Farm inspections are usually performed annually, unless the borrower has a livestock feeding operation or some other type of operation that involves frequent turnover of assets. Generally, it is desirable to inspect feeder operations approximately every six months or more frequently if deemed necessary. The absence of a current inspection report, especially for larger or troubled borrowers, may be considered a loan-documentation exception.

UNSOUND AGRICULTURAL LENDING PRACTICES

Following is a list of common unsound lending practices, some of which are general and apply to all types of loans while others relate more specifically to agricultural loans. This list includes the most common shortcomings. Depending on the extent of the unsound practices, the examiner should incorporate specific recommendations for improvement into the examination report or formal supervisory action where appropriate.

- absence of or failure to follow sound lending policies and procedures
- failure to require adequate performance on debt
- failure to monitor the borrower's performance and position, commonly evidenced by the—
  - —lack of periodic collateral inspections
  - —absence of current income and financial information
  - —failure to consider the borrower's total debt-service requirements
  - —presence of additional operating debt at another bank; or
  - —absence of a lien search to verify the bank's position in collateral
- inappropriate loan structuring, such as—
  - —untimely or inappropriate repayment schedules
  - —failure to identify or segregate carryover operating debt
- unwillingness to say "no" to a financially stressed borrower, which could be an indication of—
  - —overlending (building loan volume without regard to quality or long-term effects on the borrower and the bank)
  - —failure to consider borrower's management capabilities
  - —failure to analyze or project costs of production
  - —failure to observe market trends.
- lending for speculative purposes
- lending outside of the bank's normal trade area
- lending on new or unproven types of operations or operations in which bank management has little or no experience

TROUBLED AGRICULTURAL LOANS

Aside from readily identifiable problem loans such as past-due loans, loans on nonaccrual status, loans on the bank's watch list or those that were previously classified, or loans to borrowers who have filed for bankruptcy, the following characteristics may indicate existing or potential problems. Examiners should keep in mind both current conditions and trends.

- undermargined collateral position
- unusually high leverage
- marginal liquidity
- heavy investment in equipment, vehicles, or real estate
- need for unplanned credit advances
- deficiencies or problems revealed in the collateral inspection
- unfavorable financial trends (especially increasing debt-to-worth ratio or declining collateral margins)
- lack of performance (renewals without appropriate performance)
- capitalizing interest on debt
- charge-offs
- inability to meet scheduled debt payments
- tax problems
- reluctance of borrower to provide current, complete, and accurate financial information
- notification of insurance cancellation for failure to pay premium
- evidence of legal action against the borrower
- overdependence on guarantors
- overdependence on anticipated inheritance

CHAPTER 12 BANKRUPTCY

Chapter 12 bankruptcy for family farmers became effective in November 1986. It was designed specifically for the family-farm debtor and permits family farmers to reorganize farm debt so that the amount of the debt approximates the value of the collateral. Only a "family farmer with regular annual income" (which can be a partnership or corporate structure) may file a chapter 12 bankruptcy. To be eligible, a debtor must meet *all* of the following tests:

- have a farming operation
- have no more than $1.5 million in total debts

- derive at least 80 percent of total debts (excluding debt on the principal residence) from the farming operation
- derive more than 50 percent of the family's income from the farming operation during the year immediately preceding the filing

The family farmer will have regular annual income if the court finds the annual income to be sufficiently stable and regular to enable the farmer to make payments under the chapter 12 plan.

Under chapter 12, there is no requirement for accelerated payment of arrearage as there is with chapter 13. Instead, the farmer/debtor can commence making plan-required payments from the start of the chapter 12 bankruptcy. Also, a farmer/debtor will have the ability to modify a promissory note and continue payments on it beyond the life of the chapter 12 plan if the court approves the modification; in such cases, the creditor cannot object.

A secured creditor will be "adequately protected" during the chapter 12 bankruptcy if it receives cash payments to offset any decrease in the value of collateral and, in the case of farmland, if the creditor is paid a reasonable rental fee based on the earning capacity of the property. Also, chapter 12 does not allow the creditor to recover "lost opportunity costs," so the creditor will not be entitled to interest and other gains that would have been received by the creditor had bankruptcy not been filed. Elimination of the lost-opportunity-cost provision makes it more difficult for creditors to obtain a lift of stay on the grounds that there is not adequate protection.

Before confirming the chapter 12 plan, a court may permit a farmer to sell pledged assets without the consent of the secured creditor, although proceeds from the sale must go to the secured creditor. Creditors may bid at the sale, and collateral that is not sold will be subject to current evaluation in determining what amounts will be claimed by secured creditors under the plan. There is no time limit on the duration of a chapter 12 plan, except for a three-year limit (or five years with court approval) on unsecured debts.

If a chapter 12 debtor voluntarily dismisses the case, he is prohibited from refiling for 180 days. The law also provides for a dismissal from chapter 12, or a conversion to chapter 7, when the debtor commits fraud. Any other provisions of chapter 12 that are not discussed here are generally similar to those in chapter 11 and chapter 13 bankruptcy proceedings.

WORKING OUT PROBLEM AGRICULTURAL LOANS

When significant problems arise in agricultural credits, bank management resolves the problems in a timely manner to protect and strengthen the bank's condition. A sound and accurate loan-grading system, supported by a competent internal loan review program, will help to ensure timely identification of problems. Regulatory examinations provide an independent assessment, which may identify additional problems that management has not recognized. Once problems are identified, the following considerations are important in a workout program:

- identify the source of the problem
- establish a workout plan designed to strengthen the borrower and to minimize loss to the bank
- set at least a tentative timetable for the workout
- reach agreement with the borrower on the plan, if possible
- monitor progress frequently

Alternative actions in a workout plan might include—

- reducing the bank's exposure in outstanding debt by—
  - —obtaining additional collateral,
  - —obtaining financial assistance through sound cosigners, guarantors, or government guarantees,
  - —encouraging the borrower to modify his operations, or
  - —restructuring the credit to reduce the interest rate or payments
- advancing more funds to—
  - —refinance existing nonbank debt on more favorable terms or
  - —improve the bank's overall collateral position (for example, take out a small balance to a senior lender to put the bank in a first lien position)
- reducing or eliminating outstanding bank debt by—
  - —selling assets, which can range from a partial sale to reduce debt burden and improve chances for survival to a complete liquidation;

—refinancing a portion of bank debt (such as real estate) elsewhere if more favorable rates or terms are available; or

—recognizing a loss by partial or complete charge-off of the credit.

EXAMINER REVIEW OF AGRICULTURAL LOANS

A review of agricultural loans during an examination will follow the same basic guidelines employed in reviewing commercial or real estate loans. Certain practices, types of collateral, and documents may be unique to agricultural loans, and credit analysis will be somewhat specialized. However, the objectives of assessing credit quality based on the borrower's financial strength, cash flow, collateral, history of performance, and indications of management capabilities are much the same as for other loan types.

Sample size and sampling techniques will vary with the planned scope of the examination and size of the bank and its agricultural loan portfolio. As a minimum, the examination scope would usually include past-due and nonaccrual loans, watch-list loans, previously classified loans, insider loans, and some portion of other loans. See section 2080.1, "Commercial Loans," for details regarding this topic.

Classification of agricultural loans should be made using the same criteria established for other types of loans. See section 2060.1, "Classification of Credits," for regulatory definitions of substandard, doubtful, and loss classifications, as well as the special mention category and guidance on classifying loans.

1. To determine if lending policies, practices, procedures, and internal controls for agricultural loans are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the agricultural loan portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

INTRODUCTION

This section reinforces key factors in agricultural lending and provides a discussion of potential agricultural market issues and risk ramifications banking organizations and supervisory staff should consider when assessing the adequacy of the risk-management practices and capital needs for a bank's exposure to agriculture-related risks. This supervisory guidance also addresses factors that examiners should consider in evaluating individual agriculture-related credits and the adequacy of a banking organization's practices to monitor a borrower's capacity to repay given uncertain events. These concepts are based on the existing guidance within this manual's section entitled, "Agricultural Loans."[1]

A bank's risk-management and capital planning practices should be sufficiently robust to assess the level of agriculture-related credit risk and the adequacy of a bank's capital to withstand potential future market and economic distress. The risk-management principles discussed in this section are broadly applicable, irrespective of agricultural market conditions.

MARKET ISSUES AND RISK RAMIFICATIONS

Prolonged and abrupt declines in farm income, brought about by negative movements in commodity prices and/or increased production costs, could have serious ramifications for the repayment ability of previously sound farm borrowers and could result in substantial declines in farmland collateral values. Highly leveraged farm borrowers or those that are in weakened financial condition would be most vulnerable to abrupt or prolonged financial distress.

Banks should monitor a number of market factors in order to manage and control the risk of their agriculture-related loan portfolio (including collateral values for farmland) and determine the repayment ability of individual farm borrowers. These factors include the following:

- *Agricultural commodity prices.* These prices have exhibited volatility over the years.
- *Production costs.* Volatility in costs for labor, feed, fertilizer, seed, land rent, and machinery and equipment may challenge farm operators' ability to effectively manage operating profit margins.
- *Farmland values.* Surging land values can indicate capitalization rates are below historical norms and may reflect overly optimistic long-term expectations. An abrupt increase in interest rates, coupled with a decline in farm income, could trigger an increase in capitalization rates, thereby lowering farmland values.
- *Global market issues.* Global supply and demand imbalances can adversely affect commodity prices and the cost of production. For example, weather events, economic conditions, and numerous other factors can impact global supply as well as demand. For example, producers of ethanol and other biofuels may be adversely affected by the volatility in oil, corn, and other commodity prices.

SUPERVISORY EXPECTATIONS FOR CREDIT-RISK MANAGEMENT AND UNDERWRITING PRACTICES

The potential for volatile market conditions and risk factors raises the importance of ensuring that agricultural banks have in place appropriate risk-management programs and prudent lending standards. A key component of a sound risk-management program is the linkage between an analysis of market conditions and an agricultural bank's risk-management and capital planning practices. The range and extent of market analysis may vary depending on the composition of the bank's portfolio and overall risk exposure. This analysis should provide sufficient information on current market conditions, factors that could influence changes to market conditions, and possible events that could significantly change near- and long-term market conditions. Banks with significant agricultural exposure should have established risk-management practices that address the following:

- *Assessment of the Borrower's Creditworthiness.* A bank should conduct a thorough analysis of a borrower's creditworthiness, including assessments of the borrower's projected income and expenses compared to actual

1. See also, SR-11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk."

results, adequacy of working capital, capital expense analysis, reliability of supplementary sources of income, and cash flow stress test analysis. Current borrower financial information is essential to the bank's ability to evaluate the borrower's creditworthiness and leverage. A successful agriculture-related business should exhibit strong repayment ability and risk analysis, liquidity, solvency, collateral, credit management, profitability, and management performance.

- *Assessment of the Borrower's Cash Flow.* In volatile markets, a highly leveraged borrower may not have the necessary cash flow to properly service the debt according to the loan terms. By reviewing the borrower-prepared cash flow statements, the bank should be able to identify potential repayment ability problems, calculate key cash flow ratios, and assess the ability of the business to handle risk and uncertainty. Risk and uncertainty due to commodity prices, production, and weather are prevalent characteristics of most farm operations and should be explained in the cash flow projections. A sensitivity analysis that determines a farm operation's ability to withstand risk and uncertainty is useful in analyzing cash flow projections, including the borrower's risk mitigation strategy. While there is a broad spectrum of agricultural activities (e.g., grain, livestock, and fruit), there are some key elements of sound financial analysis that should be applied to all situations. These elements include
  - — reviewing the reasonableness of budget assumptions and projections for yield, weight gain, production costs, and commodity prices;
  - — comparing these projections with actual performance results;
  - — assessing the impact of capital expenditures; and
  - — evaluating significant changes in the borrower's balance sheet structure.
- *Assessment of the Borrower's Risk Mitigation Strategy.* For those borrowers that employ risk mitigation strategies such as commodities derivatives to control the price of feed or feedstock and the sales price for agricultural production or crops, the bank should have a process in place to assess potential risks arising from the borrower's risk mitigation practices. The bank should conduct sufficient analysis to determine when such activities could pose a risk to the borrower's cash flow projections or ability to repay debt on the agreed upon loan terms.
- *Underwriting Standards.* A bank should periodically review its underwriting standards to ensure that loan policies do not become outdated and ineffective. The frequency and depth of the review will depend on circumstances specific to each institution, such as growth expectations, competitive factors, economic conditions, and the bank's overall financial condition. Planned changes to a bank's lending function or business plan should prompt a modification to lending policies. The appropriateness of minimum debt-service-coverage ratios and maximum loan-to-value ratios should be assessed. Significant criticisms and recommendations made during recent audits and examinations should also be considered during the updating process.
- *Credit Administration and Controls.* A bank should have appropriate policies and controls to monitor and segregate agricultural carryover debt. Bank management should understand the fundamental causes of carryover debt. Carryover debt resulting from the borrower's inability to generate sufficient cash flow from sales to repay the current cycle's production loans generally reflects a well-defined credit weakness. The identification of a troubled borrower does not, however, prohibit a banker from working with the borrower. When carryover debt arises, the bank should confirm the reasons for the carryover debt (e.g., weaknesses in a borrower's financial condition or operations, inappropriate credit administration on the bank's part, a poor marketing plan, or adverse weather conditions), as well as the viability of the borrower's operation so that an informed decision can be made on whether debt restructuring is appropriate. The restructured debt should generally be on a term basis and require clearly identified collateral, a reasonable amortization period, and payment amounts based on realistic expectations.
- *Loan Structure.* The structure of a loan will depend on the nature of the borrower's business. To properly structure the borrowing relationship, the bank should be able to
  - — project how the borrower will perform in the future, including likely primary and secondary repayment sources;
  - — anticipate challenges and problems that the borrower may encounter;

- match the type and terms of the loan to both the loan purpose and the likely repayment sources and ensure the loan is supported by sufficient cash flow from the expected repayment source;
- develop a set of loan agreement covenants that protects the bank for the term of the loan; and
- secure the credit facility with collateral and consider requiring loan support such as guarantees.

• *Reliable Collateral Evaluations and Reasonable Collateral Margins.* A bank should have a process in place to monitor periodically the value of collateral pledged to the debt in order to manage the risk over the life of the loan. Evidence of collateral lien perfection and timely collateral inspections should be documented in the loan file review. Evidence of declining collateral margins may signify emerging concerns over the ability of the borrower to repay and could adversely affect the bank's collateral protection in the event of default.

The level of sophistication of risk-management systems should vary based on the specific risk characteristics, complexity, and size of the bank's exposure to agriculture. In general, there should be higher expectations around risk-management systems and management oversight for banks with significant exposures to one or several agricultural sectors. An institution should assess the effect, if any, of its agricultural credit activities upon the institution's overall financial condition, including capital, the allowance, and liquidity.[2]

2. See, respectively, SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies." See also the following sections in this manual: section 2012.1, "Allowance for Loan and Lease Losses," section 2013.1, "Allowance for Credit Losses," and section 3200.1, "Liquidity Risk."

INTRODUCTION

This section is intended to provide guidance on prudent risk management of energy lending activity to examiners reviewing reserve-based lending, usually to exploration and production (E&P) firms.[1]

Reserve-based lending or reserve-based loans (RBL) is a type of financing where a loan is secured by the reserves of oil and gas of a borrower and repaid primarily using the proceeds from the future sale of encumbered oil or gas reserves. The amount of an RBL is determined based on the borrower's "proved reserves" borrowing base, adjusted for certain risk factors. Categories of proved reserves include proved-developed-producing, proved-developed-nonproducing, and proved-undeveloped reserves.

A bank engaging in reserve-based lending should maintain a robust risk management program to manage and control the level of risk in and concentration of its reserve-based lending portfolio. The program should include timely market condition analysis that supports sound credit risk management and underwriting practices. The range and extent of market analysis may vary depending on the composition of the institution's energy-related loan portfolio and overall risk exposure to the energy industry. The analysis should provide an institution's management and its board of directors with sufficient information on market conditions to make informed decisions regarding both loan and portfolio risk changes.

OIL AND GAS INDUSTRY OVERVIEW AND BUSINESS DESCRIPTION

The Oil & Gas (O&G) industry comprises three business segments—upstream, midstream, and downstream:

Upstream companies, also known as Exploration and Production (E&P) companies, find, develop, and produce oil, natural gas, and natural gas liquids. The upstream business model is analogous to mining for raw materials. Upstream companies manage their development and production costs and emphasize production volume to generate profit margins, which are sensitive to commodities market prices. Commodity price changes can cause volatility in company cash flow and the value of O&G reserves.

Upstream companies make up-front investments to obtain and develop reserves from which they expect to generate satisfactory investment returns based on their expectations for production costs, production volumes, and future market prices. Once production begins, the existing O&G reserves start to deplete. Therefore, upstream companies require high levels of ongoing capital expenditures to maintain or increase reserves to offset depletion. Sustained periods of capital investment can reduce the amount of cash flow available for debt service or distributions.

The primary assets of an E&P company are its oil and gas reserves, that is, hydrocarbons below the earth's surface that have not yet been produced and are economically viable to extract. E&P firms are unique in that their primary asset base is depleting and therefore must be continually replaced through either drilling activities or acquisition. Lending to E&P companies are based solely on the predicted cash-flow value of the oil or gas production. Reserve-based lending is secured by interests in oil and/or gas properties with proved reserves. Cash flow generated from the future sale of encumbered oil and/or gas reserves is the primary, and in some cases, the only credible source of repayment. Therefore, production payments are usually assigned to the bank, and the liquidation value of collateral is expected to be sufficient to pay off the loan at any time. In considering this or any type of secured loan, the banker must assess a borrower's creditworthiness. (See the subsection entitled "Credit Risk Management and Administration" for more information.)

Because cash flow generated from the future sale of oil or gas is the justification or basis for production lending, proved-producing reserves are the most desirable collateral for a bank as they provide sufficiently predictable cash flow for debt service. For this reason, loan values are predicated primarily on reserves that are proved-developed-producing properties.

Midstream companies gather, process, store, and transport crude oil, raw natural gas, natural gas

1. See SR letter 16-17, "Supervisory Expectations for Risk Management of Reserve-Based Energy Lending Risk," for more information.

liquids, and refined petroleum products and chemicals. The midstream business model is similar to a toll road that charges fees for the movement or intermediate processing of O&G. Midstream companies require large up-front investments in long-lived infrastructure and then generate medium to low profit margins by collecting fees for services. These companies frequently are structured as master limited partnerships, which are not subject to income tax.

Downstream companies refine petroleum products and engage in the manufacturing, marketing, and distribution of refined petroleum products such as gasoline, jet fuel, heating oil, asphalt, motor oil, and lubricants. The downstream business model is similar to value-added manufacturing that earns low to medium profit margins from refining raw materials, turning them into products with valuable uses, and marketing and delivering finished goods to wholesale customers and end users. Developing the capacity to do so requires high capital investment up front. Large downstream companies may incorporate elements of upstream and midstream businesses.

O&G service companies provide support to upstream, midstream, and downstream operations. E&P and integrated O&G companies, specifically, are supported by various types of service companies that provide geological surveys, engineering, technology, drilling, extraction, processing, transporting, wastewater disposal, and other services. These service companies are capital intensive and can be highly complex and technologically advanced. Some service companies are large and multinational, and others are quite small, such as local trucking companies, small engineering firms, and small maintenance firms.

Integrated O&G companies are involved in almost every aspect of the O&G business: upstream, midstream, and downstream. This structure may better enable such companies to successfully manage business cycle risks and price risks. Most of these companies also manufacture and sell petrochemicals. International integrated O&G companies conduct their operations worldwide and are among the largest and most recognized companies in the world. Comparatively, smaller and independent integrated O&G companies have less diversification and may exhibit greater vulnerability to commodity price volatility, cost overruns, production delay disruptions, and economic cycles.

DEFINITIONS OF RESERVES

Reserves[2] are quantities of petroleum that E&P companies anticipate they will be able to recover commercially from known accumulations from a given date forward under defined conditions. Reserves must be discovered, recoverable, commercial, and remaining as of the evaluation date. Reserves are classified into one of three categories: proved, probable, or possible, with proved reserves divided into three subcategories: proved developed producing, proved developed nonproducing, and proved undeveloped.

Proved Reserves (1P) are of the lowest risk classification. This means that under current conditions, it is reasonably certain that the reserves will be recoverable and commercial (i.e., profitable to produce).

- *Proved-developed.* Proved reserves are considered developed only after the necessary equipment has been installed or when the costs to do so are relatively minor. There are two subcategories of developed reserves: producing reserves and nonproducing reserves.
  - — *Proved-developed-producing (PDP) reserves*. PDP reserves are those quantities of petroleum which, by analysis of geological and engineering data, can be estimated with reasonable certainty (90 percent) to be commercially recoverable, from a given date forward, from known reservoirs and under current economic conditions, operating methods, and government regulations.
  - — *Proved-developed-nonproducing (PDNP) reserves.* These are generally proved-developed reserves behind the casing of existing wells or at minor depths below the present bottom of such wells that are expected to be produced through these wells in the predictable future; including proved developed shut-in (PDSI) and proved developed behind the pipe reserves.

2. For more information, please refer to "Petroleum Reserves Definitions," Society of Petroleum Engineers, last modified March 1997, www.spe.org/industry/petroleum-reserves-definitions.php.

The development cost of this type of reserves should be relatively small compared with the cost of a new well.

- *Proved-undeveloped (PUD) reserves.* These are reserves that are proved resources to be recovered from new wells on undrilled acreage or from existing wells requiring a relatively major expenditure for recompletion to a producing state. A company's proved-undeveloped reserves should be economically and technically viable for development.

Probable Reserves (2P) are those unproved reserves which analysis of geological and engineering data suggests are more likely than not to be recoverable. In this context, when probabilistic methods are used, there should be at least a 50 percent probability that the quantities actually recovered will equal or exceed the sum of estimated proved plus probable reserves.

Possible Reserves (3P) are those unproved reserves which analysis of geological and engineering data suggests are less likely to be recoverable than probable reserves. In this context, when probabilistic methods are used, there should be at least a 10 percent probability that the quantities actually recovered will equal or exceed the sum of estimated proved plus probable plus possible reserves.

TYPES OF OWNERSHIP INTEREST IN OIL & GAS RESERVES

Ownership interests related to reserves can be held in a variety of forms including royalty (or mineral) interests, overriding royalty interests, and working interests. Royalty interests are created when the mineral interest owner leases a property. Royalty interests represent payments to mineral owners to drill on their property take preference over all other payments from lease revenue. Overriding royalty interests are similar to royalty interests except these may have limited value as they are dependent on production. Working interest owners share in the profits after the royalty interest payment, lease operating expenses, severance and ad valorem taxes, and capital expenditures associated with a property (lease or well), as well as the risks associated with drilling.

FUNDING SOURCES AND CAPITALIZATION

A traditional role of bank credit in the O&G industry has been to finance E&P capital expenditures. The repayment of E&P loans depends primarily on revenues and cash flows generated by the successful acquisition, development, completion, and production of O&G reserves, and secondarily on the liquidation of O&G reserves securing the debt.

There are several loan structures used by E&P companies to finance their businesses. Most independent, non-integrated E&P companies obtain financing through an RBL. An RBL typically is a revolving facility secured by proved reserves with the amount of the borrowing base determined by the valuation of those reserves.

RBLs typically have terms of three to five years. The RBL's purpose is primarily to fund acquisition and development costs of new reserves, which, if successful, increase the reserve valuations and provide increasing cash flow for debt service and profits for the company's shareholders and investors. Other forms of debt, such as senior notes or bonds, are normally subordinate to the RBL in collateral position, but in certain cases, second-lien loans are pari passu with the RBL in right of contractual payment streams.

Although less common in the United States, another credit structure that E&P companies use is a reducing revolver, which is a combination of a revolving loan and a term loan. The revolver can increase to a maximum commitment level and then step down at regular principal payment dates.

Lenders may also make term loans for project financing, acquisition of O&G properties, or acquisition of other fixed assets secured by a first lien on the company's reserves. For term loans, banks determine the lendable amount based on engineering reports and make a one-time advance for the acquisition. This type of financing amortizes over the loan term or the principal balance is paid at maturity. The term of loans typically varies from five to 10 years, but the term of these loans should always be tied to the economic life of the underlying asset.

Banks have historically been the primary financial provider of RBLs but other market participants are active in providing additional sources of capital to the industry. Examples of other forms of capital extended to the sector include the following:

- Second-lien debt: In energy lending, second-lien senior term loans may rank pari passu in right of payment with first-lien debt, including RBLs because of the additional risk to repayment but remain in a secured position ahead of unsecured debtors, such as bondholders. Second-lien loans often are structured with five-year maturities with interest-only payment requirements.
- Mezzanine debt: Mezzanine loans are subordinated to senior loans and are used to leverage acquisition or development activities, particularly when companies do not have sufficient producing reserves to support borrowing under an existing RBL. These loans may have tight covenants and extensive controls on funding and are generally unsecured and not subject to a borrowing base; rather, these loans are based on collateral coverage or cash flow ratios.
- Bonds: High-yield bond offerings and securitizations have played an important role in E&P financing by providing affordable access to capital markets. Longer-term bond offerings with 10-year maturities and interest-only payments have been common sources of funding for E&P companies.
- Private equity: Equity investors in the E&P industry play a significant role in E&P ownership and related financing structures. The increasingly complex corporate structure of E&P companies also requires that E&P lenders have more specialized expertise and monitoring systems.

Examiners should determine whether other financing sources are utilized, in addition to the loan under review, to meet the capital needs of the borrower. For example, banks that lack the in-house capacity to fund first- and second-lien facilities can either pair up with a mezzanine capital provider or try to stretch its borrowing base underwriting algorithms in an effort to meet a borrower's cash needs. This generates additional risk to the bank and may affect the liquidity and repayment capacity of the borrower.

EVALUATION OF RESERVES

When a lender decides to proceed with financing secured by oil or gas reserves, a bank obtains an engineering report. The initial step to determining the loan value of the collateral or assessing the borrower's creditworthiness is an analysis of the engineering report.

Banks that make RBLs will usually have a petroleum engineer on staff or contract with an engineering consultant firm to provide an engineer's report on the properties to be pledged. An engineering report provides reserves and production forecasts and then applies the pricing and cost assumptions to arrive at the net lease operating income available for debt service. This report is comparable to a real estate appraisal in its importance and function to the bank's credit decision.

Typically, most reports will cover five or more years. Production is usually broken down into categories of oil and gas, and sometimes the number of wells is detailed. Expenses may be divided into major components such as operating costs; production and ad valorem taxes; depreciation, depletion, and write-off of intangibles; general and administration expenses; and taxes on income. Also, if the owner expects to make capital improvements from income, this information will be included in the report. Some reports include the pro forma amount and terms of the loan to support the analysis.

Engineering reports must be generated by a fully qualified petroleum engineer. The lender should select an engineer based on the individual's competency, experience, and independence, as well as the individual's analytic skills. The integrity of engineering data that depict future cash stream is critical to the initial lending decision and equally important to an examiner in the assessment of credit quality. In summary, an acceptable engineering report must be an independent, detailed analysis of the reserves prepared by a competent engineer.

The examiner should carefully review the four elements below in establishing the amount of the borrowing base.

Pricing

When reviewing the engineering report, an examiner should carefully review the underlying pricing and production assumptions used. West Texas Intermediate (WTI) and Brent are the most common sources for benchmark prices used in engineering reports, but the actual price that is realized can vary significantly by wellhead. The difference between benchmark price and wellhead price is referred to as price differential. Factors affecting the price differential can include oil quality, transportation, and storage, to name a few. Banks should be able to support the pricing used in their forecasts, ensuring that benchmark prices are reasonable as compared to the wellhead prices.

E&P companies are exposed to the price volatility in commodity markets. In response, E&P companies may vary their production level and capital expenditures based on current and future price expectations, or hedge their reserves by utilizing the futures markets. A price sensitivity analyses should be run to test the valuation range, and long-term flat price cases should be run to test valuation at the floor or bottom price levels. Sound banking practices include a stress or downside analysis based on significantly lower prices.

The future price of oil is a judgment factor and should be based on conservative pricing and can include some reasonable escalation each year. This information can be obtained from a number of reliable sources, such as the NYMEX strip pricing. An examiner should determine the source of the data to judge the reliability of report information. The prices used for gas are usually contract prices plus escalation-clause rates. Special care is necessary in evaluating gas contracts, including their reasonableness in light of current conditions and the ability and willingness of the purchasers to honor the contracts. In some instances, certain purchasers have broken contracts or exercised "market-out" clauses to cease complying with long-term purchase commitments. The Securities and Exchange Commission (SEC) requires reserves with renegotiable contracts or under market-out clauses to value the reserves at spot prices at the date of renegotiation or immediately, in the case of market-out clauses.[3]

Cost

Cost assumptions should also be realistic and fully supported. Operating cost assumptions are based on the costs of similar operations in similar areas or, in the case of producing reserves, on historical performance, which may be escalated at some reasonable percentage each year. The report should consider increases and decreases in price as well as cost inflation over the "life of the properties."

Costs affect the economic life of reserves primarily in two ways: development costs and production costs. Production costs are a key focus in underwriting because the borrowing base is based primarily on PDP reserves. Production costs include lifting costs or lease operating expenses, which include operating and maintenance expenditures for materials, supplies, fuel, insurance, maintenance, and repairs. Additional production costs include property and severance taxes. If there are plans for further development, engineering reports may include development costs, or capital expenditures, for PDNP and PUD properties as well. Capital expenditures may include roads, utilities, drilling pads, site facilities, development wells, wellheads, well casing, and pipe and well equipment. To a lesser extent, capital expenditures may include workover costs for PDP wells.

Discount Rate

The discount rate depends on current market factors that consider the required market rate of return on future cash flows given the relative risks involved. Assumptions used to determine the discount rate should be fully supported. SEC reporting requirements require a 10 percent discount rate.

Timing

Preferably, the report should be no more than six months old under normal market conditions; if the commodity market becomes volatile, a report less than six months old will be adequate. A report that is up to 12 months old may be acceptable in some cases; however, it should not be more than 12 months old. Change is the most important factor in determining the adequacy and timeliness of reports. Significant price fluctuations or changes in interest rates may require the examiner to adjust the valuation of the reserves to reflect current conditions.

When engineering reports do not address one or more of these four critical concerns, the examiner should challenge management to pro-

3. For more information, see 17 CFR 210.4-10, "Financial accounting and reporting for oil and gas producing activities pursuant to the Federal securities laws and the Energy Policy and Conservation Act of 1975."

vide support for the evaluation assumptions, and may need to evaluate other bank methodologies, for example, recent cash flow histories, to determine the current collateral value. In addition, appropriate comments should be included in the report of examination and recommendations or matters requiring attention made to bank management for improving its engineering reporting and requirements.

ESTABLISHING THE BORROWING BASE

The borrowing base for an RBL, determined by analyzing previous production reports and independent engineering evaluations, represents the lending commitment established from the engineering valuation of the borrower's proved O&G reserves, subject to limitations and adjustments. It governs the maximum amount of availability under the RBL at any one time. The commodity prices, risk adjustment factors, and cash flow discount rate used to determine reserve values and the borrowing base should be fully supported in the lender's underwriting documentation.

The RBL is normally secured by a first lien on the borrower's O&G reserves, the cash flow from which is the loan's primary source of repayment. Banks typically perfect liens on reserve interests that produce 75 percent to 90 percent of the economic value of the borrowing base. Banks need to pay particular attention to state laws in order to understand what is required to perfect their security interest in their collateral. Additionally, banks need to ensure that liens remain enforceable as activities occur prior a borrower's sale of minerals. For example, a bank needs to protect its collateral interest when O&G assets are temporarily transferred from the well to storage containers across jurisdictions.

The engineer is responsible for ensuring that the evaluation includes only proved-developed reserves, unless otherwise directed by the lender. The lender might give value to reserves, properties or wells that are proved-developed-nonproducing under certain conditions. The lender would, however, deduct a safety factor by lowering the value of unseasoned or non-producing reserves. The lender will not generally loan against probable or possible reserves because of the production uncertainty and speculative nature of those categories. Their inclusion as collateral is usually as an abundance of caution with little or no value assigned to them.

The engineer must make a judgment on the accuracy of future revenues predictions. The engineer evaluates geologic conditions such as sand continuity, faulting, spacing, the number of wells, the diversity of properties, well productivity, the pressure production history, and overall data quality, as well as the degree of confidence the engineers have in their own numbers. Estimates based on well-established production performance are given the most credibility. Lesser weight is given to estimates derived from more speculative methods such as volumetric, analogy with similar reservoirs, or a computer simulation of new producing zones. The examiner should carefully review the narrative portion of the engineer's report to help determine its usefulness. It will detail what data were available, how they were used, the methods of analysis, and whether a field inspection was made, including individual well tests. This section of the report should inform the examiner of the true condition of the reserves and wells. It is possible for the projected cash flow to portray one picture while the narrative portrays an entirely different one.

For example, a bank will typically loan up to 65 percent of the net present value of risk-adjusted proved-developed-producing reserves; however, a lower percentage may be needed depending on a number of factors. If the reserves are in an area that is highly faulted, or if seismic work and drilling indicated that a zone is contiguous from one well to the next and the porosity and permeability of the pay-zone rock are very similar, then a lower percentage will be used. To avoid the possibility that any individual, unforeseen event will have a significant effect on the total projection, a wide spread of properties is preferable.

A bank needs to address the risk arising from a concentration of value in any one well, as well as a concentration in one reservoir, field, or producing area. Generally, a risk adjustment factor of not less than 10 percent will be used on unseasoned (less than six months in production) proved-producing reserves, but on long-life and high-quality reserves, a risk adjustment factor less than 10 percent is sometimes used. However, reserves that are highly faulted may require a higher risk adjustment factor than 10 percent even if they are long-life and high-quality. For non-producing reserves such as PDNP and PUD reserves, risk adjustment factors typically range from 25 percent to 75 percent. Terms of an RBL will usually require that the loan be fully repaid before the risk adjustment factor is reduced. Examiners should carefully review the risk adjustment factors used by the lender for determining borrowing base commitments. In addition, there should be a limit established for the contribution of nonproducing reserves to the borrowing base. This is commonly set at no more than one third of the valuation. All bank adjustments should be fully detailed and supported.

For RBLs, a bank will periodically evaluate the borrower's O&G reserves to re-determine the borrowing base commitment. Redeterminations typically occur semiannually, but lenders and borrowers normally have the right to additional redeterminations once or twice during a year, as defined by the credit agreement.

Typical financial covenants in the RBL credit agreement include cash flow leverage, interest coverage, and current ratio covenants:

- The cash flow leverage ratio is typically defined as senior funded debt or total debt over trailing 12 months (TTM) EBITDAX.[4] This covenant is the most critical of the three main RBL covenants because it may provide the least amount of headroom while also controlling the amount of additional borrower debt. The total debt to EBITDAX covenant is frequently set at 3.5x and normally does not exceed 4.0x, unless the covenant is increased to account for an acquisition with step-downs to more reasonable leverage.
- A standard definition for interest coverage is TTM EBITDAX divided by TTM interest expense. Interest coverage covenants for RBLs may require 2.5x to 3.0x EBITDAX coverage of TTM interest expense.
- A standard definition of the current ratio is current assets divided by current liabilities less current maturities, requiring at least 1.0x to 1.25x coverage. Some transactions, however, may define the current ratio covenant as current assets plus unfunded RBL availability divided by current liabilities less current RBL maturities.

Declining commodity prices and a corresponding drop in revenues can stress these measures and limit production growth, which can lead to reduced RBL borrowing bases during redeterminations. Lenders often work with borrowers to formulate plans and implement short-term solutions.

Borrowing Base Stretch

A "stretch" occurs when the bank agrees to provide the borrower with an RBL commitment that materially exceeds the lendable amount as determined by the bank's underwriting criteria and loan policy. In a syndication, each participant calculates the RBL lendable amount separately. The calculated lendable amount may vary by bank, and some banks may agree to "stretch" to meet the higher borrowing base amount agreed upon by the syndication group. Bank approval of the stretch should be supported by documented risk mitigation methods. The approval of a stretched borrowing base should not be used to avoid borrower repayment requirements caused by an over-advance. If the stretch is not well supported, the advance should be considered in the risk rating assessment.

Repayment Analysis

The lenders normally prepare base case and sensitivity case repayment analyses as part of the underwriting process. The primary repayment source for most RBLs is cash flow generated from the sale of oil and gas production. Therefore, a borrower's future cash flow generated from the sale of oil and gas reserves should demonstrate the ability to cover projected operating expenses and repay total debt within a reasonable time.

A base case analysis should use prevailing market prices, such as NYMEX futures prices, versus the bank's commodity price deck used for borrowing base determination. The repayment analysis should be based on repayment capacity from un-risked and undiscounted revenues from the borrower's total proved reserves.

4. EBITDAX is earnings before interest, taxes, depreciation, and amortization (EBITDA) with depletion, exploration, and abandonment expense added back. These expenses are add banks because they are often considered discretionary, while also providing consistent application of the covenant regardless of whether the company uses the full cost accrual or successful efforts accounting method. EBITDAX, rather than EBITDA, appears almost universally in O&G financing documents.

TABLE 1
GENERAL FRAMEWORK FOR CALCULATION COMPARABLE EARNINGS BEFORE INCOME TAX, DEPRECIATION, DEPLETION, AMORTIZATION, AND EXPLORATION COSTS (EBITDAX)

Full Cost Method	*Successful Efforts Method*
Operation Income	Operating Income
Plus: Depreciation, Depletion and Amortization	Plus: Depreciation, Depletion and Amortization
Plus: Accretion of Asset Retirement Obligation	Plus: Exploration Expenses
Plus: Deferred Taxes	Plus: Dry Hole, Abandonment, and/or Impairment Expense
	Plus: Accretion of Asset Retirement Obligation
	Plus: Deferred Taxes
= EBITDAX	= EBITDAX

Proved reserve life is the estimated productive life of a proved reservoir based on the economic limit of producing the reserves assuming certain price and cost parameters. The economic half-life of the proved reserves represents the point in time when the borrower will have generated half of the estimated future net revenue (FNR). The reserve life and economic half-life of the reserves can be stated in months or years or as a percentage of the total FNR.

In addition, a sensitivity case analysis subjecting the oil and gas reserves to adverse external factors, such as stressed market prices or higher operating expenses, should be prepared to determine the vulnerability of the borrower's repayment capacity to adverse economic conditions.

Analyzing E&P Borrowers Financial Statements

At times it may be desirable for examiners to review E&P borrowers' financial statements analysis prepared by the bank. Such analysis should include historical production volumes as well as the average hydrocarbon prices received for the periods under review. As hydrocarbons are a commodity, physical volumes produced and commodity concentrations indicate the borrower's sensitivity towards market price fluctuation. Production volumes are typically expressed as barrels of oil equivalent (BOE) or thousands of cubic feet equivalent (MCFE) for gas.

Other analytical ratios, such as lifting costs (lease operating expenses per BOE or MCFE produced during a period) and finding costs (costs associated with increasing reserves during a particular period) should also be calculated and reviewed. The quantitative measures of E&P performance are based primarily on the ability to replace and grow resources at a favorable cost, in contrast to profit margins and growth for traditional industrial companies.

Another primary pricing metric for E&P companies is EBITDAX. EBITDAX represents EBITDA (earnings before depreciation, interest, taxes, and depreciation and amortization) before *exploration costs* for "successful efforts" companies; for "full cost" firms, exploration costs are embedded in depreciation and depletion. (See table 1.) In addition, other noncash expenses such as impairments, accretion of asset retirement obligation, and deferred taxes should be added back in calculating EBITDAX. Free cash flow should also be considered where cash income taxes and capital expenditures are deducted from EBITDAX.

SAMPLE CASE

Table 2 below provides a sample repayment analysis for determining the borrower's ability to repay total secured debt within a reasonable time.

Cash flow available for debt repayment is equal to projected future net revenue (FNR) less general and administrative (G&A) expenses and interest expense on total debt (column J). The beginning borrowing base commitment (column K) is reduced by the incremental cash flow available for debt repayment from each period until payout and then applied to junior lien secured debt (column N). At payout, the FNR remaining (column Q) divided by the aggregate FNR represents the reserve tail (column R).

Examiners should evaluate the borrower's ability to repay total secured debt, including a fully funded RBL and interest expense on all debt. When it is unlikely that the borrower will use the full RBL commitment to fund projected capital expenditures or deficit cash flow, however, examiners may also run scenarios of the borrower's repayment capacity reflecting actual or anticipated usage on the RBL. The ability of the borrower to repay or refinance unsecured debt should consider the maturity structure and any contractual repayment obligations of the unsecured debt relative to the repayment capacity of the total secured debt.

TABLE 2
BORROWER CASH FLOW REPAYMENT ANALYSIS

	A	B	C=A+B	D	E	F	G=C–D–E–F	H	I	J=G–H–I
Year Ending	Oil, gas and NGL Revenues	Hedging Revenues (Losses)	Total Revenue	Total Lease Operating Expense (LOE)	Production/Ad Valorem Taxes	Capex	FNR	G&A	Total Interest Expense	Cashflow Available for Repayment
Year 1	48,892	8,699	57,591	6,623	733	6,917	43,318	2,512	8,500	32,306
Year 2	53,401	7,783	61,184	7,036	801	34,601	18,746	2,667	7,369	8,709
Year 3	45,003	3,919	48,922	5,626	675	3,412	39,209	2,131	7,064	30,013
Year 4	42,486		42,486	4,886	637		36,963	1,848	6,014	29,101
Year 5	37,965		37,965	4,366	569		33,030	1,651	4,987	26,391
Year 6	36,455		36,455	4,192	547		31,716	1,586	2,348	27,782
Year 7	28,068		28,068	3,228	421		24,419	1,221		23,198
Year 8	26,094		26,094	3,001	391		22,702	1,135		21,567
Year 9	21,075		21,075	2,424	316		18,335	917		17,418
Year 10	16,860		16,860	1,939	253		14,668	733		13,935
Remainder	67,750		67,750	7,791	1,016		58,943	3,092		55,851
Total	424,049	20,401	444,450	51,112	6,359	44,930	342,049	19,493	36,282	286,274

	K	L=J	M=K–L	N	O=J–L	P=N–O	Q=Total FRN–G	R=Q+Total FRN
Year ending	Beginning RBL (Total Commitment)	Cash Repayment	Ending RBL Bal.	Beginning Junior Secured Debt	Cash Repayment	Ending Junior Sec. Debt	Year-end FNR remaining	FNR remaining percent
Year 1	100,000	32,306	67,694	50,000		50,000	298,730	87%
Year 2	67,694	8,709	58,985	50,000		50,000	279,984	82%
Year 3	58,985	30,013	28,971	50,000		50,000	240,775	70%
Year 4	28,971	28,971	0	50,000	129	49,871	203,812	60%
Year 5				49,871	26,391	23,480	170,783	50%
Year 6				23,480	23,480		139,067	41%

CLASSIFICATION GUIDELINES FOR RESERVE-BASED LENDING

The classification of an RBL is like all loan classifications in that it must be predicated on an independent assessment of all credit factors that are germane to the specific credit being reviewed. A comprehensive analysis of the credit should take place if any of the following factors are present:

- The loan balance exceeds 65 percent of the discounted present worth of future net income (PWFNI) of proved-developed-producing reserves, or the cash-flow repayment analysis indicates that the loan will not amortize within 60 percent of the economic life of the proved reserves (alternatively, 120 percent of the economic half-life), and within 75 percent of the economic life for total secured debt.
- The credit is not performing in accordance with terms or payment of interest and/or principal.
- The credit is identified by the bank as a problem credit.
- Other factors indicate a potential problem credit.

After performing the analysis, the examiner must determine if classification is warranted. When classification is warranted, the following guidelines are to be applied when repayment of the debt is solely dependent on oil and/or gas properties pledged as collateral. A lesser percentage or less severe criticism may be appropriate when other reliable means of repayment exist for a portion of the debt.

Proved-Developed-Producing Reserves

Sixty-five percent of discounted PWFNI should be classified substandard when the discounted PWFNI is determined using historical production data (decline-curve-analysis engineering). When less than 75 percent of the reserve estimate is determined using historical production data, or when the discounted PWFNI is predicated on engineering estimates of the volume of oil or gas flow (volumetric and/or analogy-based engineering data), the collateral value assigned to substandard should be reduced accordingly. The balance, but not more than 100 percent of discounted PWFNI of proved-developed-producing (PDP) reserves, should be extended doubtful. Any remaining deficiency balance should be classified loss.

Other Reserves

In addition to PDP, many reserve-based credits will include proved-developed-nonproducing reserves, shut-in reserves, behind-the-pipe reserves, and proved-undeveloped properties (PUPs) as collateral. Due to the nature of these other reserves, there are no strict percentage guidelines for the proportion of the credit supported by this type of collateral that should remain as a bankable asset. However, only in very unusual situations would the proportion of collateral values assigned to a classification category approach the values for PDP. The examiner must ascertain the current status of each reserve and develop an appropriate amount.

Examples could be reserves that are shut in due to economic conditions versus reserves that are shut in due to the absence of pipeline or transportation. PUPs require careful evaluation before allowing any bankable collateral value. An example of a bankable value for a PUP could be one that has a binding purchase contract. In every classification where a bankable value is given for any of these other reserves, the loan write-up should fully support the examiner's determination.

The above guidelines apply to production loans that are considered collateral-dependent and are devoid of repayment capacity from any other tangible source. Rarely should bankable consideration be given to loans that are completely collateral dependent in excess of the liquidation value of the pledged reserves. Once again, there is no substitute for a specific, case-by-case analysis of applicable credit and collateral factors pertaining to each individual credit. Frequently, when a lender encounters problems with a production credit, numerous other types of assets (for example inventories, or real estate) are encumbered in an effort to protect the bank's interests. Other types of collateral and sources of repayment should be carefully evaluated on a case-by-case basis.

DOCUMENTATION

The documentation for a term RBL is relatively simple. There is a note, a loan agreement, a deed of trust or mortgage, an assignment of production (usually in the mortgage), a title opinion, and a security agreement or financing statement. The assignment of oil and gas interests is unique because oil and gas are treated as real property while in the ground but convert to personal property interests as production is generated at the wellhead. Most lenders also require an affidavit as to payment of bills. Also, the owner or the operator is usually required to guarantee payment of the loan.

The bank will obtain an acceptable title opinion that indicates the borrower has, on the date of the loan, clear title to each of the leases under mortgage and that properties are free and clear of all liens. The bank should also perform a lien search to determine the existence of any previous liens before funding and should document the lien search in the loan file. After the loan is closed, the bank will send a letter of instruction to notify the company sending out production checks that the bank has taken a lien on the production and to request that production checks be sent directly to the bank. The mortgage covers surface rights and mineral interests. A copy of the mortgage containing an assignment of production will be sent to the company purchasing the production, along with a request that division orders or transfer orders be prepared recording its interest in production payments. This authorizes the purchaser to send production payments directly to the bank for the account of the borrower. The security agreement and financing statement covers removable equipment, oil and gas inventory above the ground, and accounts receivable. The financing statements are filed in the real estate records of the county in which the properties are located (usually with the county clerk) and in the secretary of state's office. This filing is done to perfect security interests in equipment, which may be moved from place to place. However, some states have different requirements, and the examiner should be familiar with each state's filing requirements. The affidavit as to payment of bills is executed by the borrower to ensure that all the bills have been paid on the properties or will be paid out of loan proceeds. If bills are to be paid out of proceeds, the bank should ensure that payments are verified. The examiner should review the loan agreement and, in particular, review both positive and negative loan covenants.

The bank will usually take a collateral interest in equipment, accounts receivables, and inventory. The deed of trust or real estate mortgage will cover real estate, surface rights, and mineral interests, and a security agreement will cover removable equipment, oil as inventory (in tanks), and accounts receivable. An appropriate filing is needed for each type of collateral to perfect the bank's security interest. Filing requirements may vary from state to state and should be researched. Generally, collateral documents should be filed with the state and county. It is reasonable to expect the bank to have collateral files completed within two to three months.

MARKET ISSUES AND RISK RAMIFICATIONS

Prolonged declines in crude oil prices often result in substantial declines in crude oil and natural gas reserve collateral values and associated cash flows, challenging the loan repayment ability of oil and gas exploration and production borrowers. Highly leveraged borrowers and those that are in weakened financial condition are most vulnerable to these market conditions. Banks should monitor market factors to better manage and control the risk of their reserve-based lending portfolios and to determine the repayment ability of their borrowers. These factors include

- *Oil and gas commodity prices.* Commodities are particularly susceptible to price volatility. Global supply and demand imbalances can affect commodity prices and the cost of production. For example, weather events, economic conditions, and numerous other factors can alter global supply as well as demand and place downward pressure on exploration and production company performance. Banks should take market developments and price volatility into consideration when critically reviewing collateral valuation assumptions and managing their reserve-based lending exposure.
- *Production costs and capital expenditure.* Production costs are also known as "lifting costs." These costs are incurred in the operation and maintenance of wells, related equipment, and

facilities, and can affect sustained production. Banks should critically review production costs and capital expenditures when determining borrower repayment capacity, financial viability, and liquidity. Additionally, production costs can vary significantly between wells and fields. Banks should use location-specific production cost and capital expenditure estimates instead of general assumptions, particularly for those reserve-based lending portfolios containing wells in different oil fields.

- *New technological drilling and completion improvements.* For example, horizontal wells with multistage hydraulic fracturing completions, have significantly increased the up-front capital needs for exploration and production borrowers. Banks engaging in exploration and production lending should understand the capital needs of these borrowers, including the use of new technologies, when determining borrower repayment ability. As reserves are depleted, additional capital spending is required to bring additional reserves into production and maintain productivity levels.
- *Lease provision and maintenance.* Oil and gas leases generally include a "continuous drilling" or "continuous operations" clause to prevent the lease from expiring at the end of the primary term while drilling operations are in progress. It gives the lessee the right to continue drilling any well that was begun before the lease expired and to begin drilling more wells. Maintaining production in order to exercise these lease maintenance clauses can potentially cause financial challenges to a borrower, particularly during weak market conditions. Banks should understand the scope of lease maintenance clauses in place and assess the borrower's ability to remain in compliance during stressed time periods.

CREDIT RISK MANAGEMENT AND ADMINISTRATION

Banks should have in place appropriate risk management programs and prudent underwriting standards for reserve-based lending. A risk management program should cover concentration limits and market condition analysis, as well as expectations to identify, measure, monitor and control concentration risks associated with reserve-based lending. Moreover, an institution's risk management program for reserve-based lending should be effectively integrated into its capital planning practices. A bank should regularly review its policies and practices for reserve-based lending, including any relevant contingency plans in the event of market changes, and should maintain capital levels commensurate with the level and nature of its reserve-based lending exposure. The information that follows should be considered whether the bank is lending directly or as a participant in a group, such as in the case of a syndicated loan.

At a minimum, an institution with significant reserve-based lending exposure should have established risk management practices that address the following items below.

Individual Reserve-Based Lending Credit Monitoring

- *Assessment of a borrower's creditworthiness.* An institution should conduct a thorough analysis of a borrower's past and prospective creditworthiness, including
  - — Projected income and expenses compared to actual results, as well as the results of peer oil and gas producers in the region,
  - — Working capital adequacy,
  - — Capital expense analysis,
  - — Cash flow analysis, and
  - — Price sensitivity analysis.

Current borrower financial information is essential to the institution's ability to evaluate the borrower's creditworthiness, leverage, and liquidity. A creditworthy exploration and production business should exhibit strong repayment ability, risk analysis, liquidity, solvency, reserve valuation, credit management, profitability, and management performance.

- *Assessment of a borrower's cash flow.* In volatile markets, a highly leveraged borrower may not have the necessary cash flow to properly service its debt according to the loan terms. By reviewing borrower-prepared cash flow statements, an institution should be able to identify potential repayment ability problems, calculate key cash flow ratios, and assess the ability of the business to handle risk and uncertainty.

Risk and uncertainty due to market factors, commodity prices, and production levels are prevalent characteristics of most exploration and production operations and should be reflected in the cash flow projections. A sensitivity analysis that determines an exploration and production operator's ability to withstand fluctuations in commodity prices and uncertainty in production levels is critical in analyzing cash flow projections. Some key elements of sound financial analysis that an institution should conduct include

— Reviewing the reasonableness of underlying assumptions and projections for production, pricing, and price differentials;
— Comparing these projections with historical production and performance results;
— Analyzing hedges in place as of collateral valuation date;
— Assessing the impact of changes in capital expenditures on production levels; and
— Evaluating a borrower's ability to timely service total debt and significant changes in its balance sheet structure.

• *Reliable collateral evaluations.* Valuation of oil and gas reserves demands expertise and industry experience. The interconnected nature of the energy industry is complex and demands breadth and depth of understanding across all business sectors which include upstream, midstream, and downstream segments. Specialized contracts with energy services providers, such as transportation to market or delivery point, should be carefully reviewed as part of risk management practices for reliable collateral valuation.

A typical reserve-based lending credit facility requires a borrower to deliver an updated reserve engineering report twice a year to the lender. A bank should identify additional costs and value adjustments not included in the engineering report, such as information on land mortgage restrictions and lease assignments, and use this information to understand the scope and limitation of the collateral securing the reserve-based lending. A bank should assess the assumptions contained in the reserve report, as this information forms the basis for its analysis of the reserve valuation.

A bank should have a well-defined and consistently applied process, including minimum frequency, for obtaining independent reserve engineering reports. These reports require significant industry expertise and should include a complete analysis of the wells and production requirements from current production and over the life of a well.

A bank should periodically conduct independent assessments of reserve valuation. Depending on the level and complexity of reserve-based lending in its portfolio, an institution should utilize its own independent staff engineers (if available) or retain independent petroleum engineers to conduct a comprehensive assessment of reserve valuation. This assessment should consider such factors as the relevant production volumes, expected ultimate recovery of reserves, and capital expenditures needed to convert reserves into production. An institution should also have processes in place to monitor periodically (at minimum, twice a year) the value of collateral pledged in order to manage repayment risk over the life of the loan. An institution's processes, risk adjustment factors, and discount rates for reserve analyses should be well defined in policy and consistently applied. Additionally, evidence of collateral lien perfection and collateral inspections should be documented in loan files.

• *Loan structure.* The structure of an RBL should depend on the nature of a borrower's business. To properly structure a borrowing relationship, a bank should be able to

— Project how the borrower will perform in the future, including likely primary and secondary repayment sources from producing and developing assets. There should be limits to the portion of repayment capacity derived from developing assets.
— Anticipate challenges and problems that the borrower may encounter, such as commodity price volatility, operational risks, and lease maintenance requirements.
— Match the type and terms of the loan to both the loan purpose and the likely repayment sources. This includes ensuring the loan is supported by sufficient cash flow from the expected repayment source, particularly when an RBL's collateral includes undeveloped fields (that is, proved-developed-nonproducing reserves and proved-undeveloped reserves) or fields that

do not have a continuous production history as collateral. The primary source of repayment is typically proved producing reserves.

— Develop loan agreement covenants that protect the bank, including provisions for monitoring the borrower's expenditures for the term of the loan. For example, a forward-looking liquidity test should provide a bank with visibility to the future consolidated liquidity position of the borrower and all guarantors to the loan. In addition, covenants should require the borrower to obtain the bank's approval prior to lifting any hedges upon which the institution is relying to mitigate collateral market value fluctuation.

— Secure the credit facility with collateral and consider requiring the borrower to provide loan support such as guarantees and hedges for commodity price volatility. Any guarantor should be included in the loan agreement. A bank should have processes and procedures in place to limit a borrower's commodity price hedging to its total production and thereby avoid over-hedging.

- *Risk rating credit facilities.* A bank should have in place a robust process to risk rate RBLs. Risk rating for RBLs should be based on realistic repayment assumptions for a borrower's ability to de-lever and repay the RBL and its total debt relative to the economic life of the borrower's oil and gas reserves. Financial support or credit enhancement from a sponsor (such as the borrower's parent company) should be demonstrated and documented for rating conclusions.

- *Timing of collateral impairment testing and impairment indicators.* Generally, RBL terms require a borrower to prepare a reserve impairment assessment at least annually, and more frequently depending on events or changes in circumstances. A bank should review the reserve impairment assessment report and associated recoverability test of pledged assets' value whenever events or changes in circumstances indicate that a pledged asset's carrying amount may not be recoverable.

Reserve-Based Lending Portfolio Monitoring

- *Underwriting standards.* An institution should periodically review its underwriting standards to ensure its reserve-based lending policies do not become outdated, ineffective, or unaligned with its stated risk appetite. The frequency and depth of the review will depend on circumstances specific to the institution, such as growth expectations, competitive factors, economic conditions, and overall financial condition. An institution's management should review and modify, as appropriate, reserve-based lending policies based on any planned changes to its reserve-based lending function or business plan. An institution should also address significant criticisms and recommendations about its underwriting standards that have been identified in recent audits and examinations.

- *Concentration limits.* In general, a bank should monitor and manage its aggregate energy lending portfolio to avoid concentration risk. The institution should set risk limits for reserve-based energy lending as well as energy services lending that are consistent with the risk appetite approved by the board of directors. In addition, an institution should monitor and manage its production and regional concentration risk for exploration and production borrowers to avoid any single well or field accounting for a high percentage of its energy-related loan portfolio.[5] For a bank with a lending footprint that is primarily in oil-dependent geographies, the bank should also be mindful of high correlations between energy and non-energy business in the local economy. The risk amplification that occurs during an extended commodity sector downturn should be heavily factored into concentration and risk analysis.

- *Credit administration and controls.* An institution should have appropriate policies and controls to monitor and separately manage troubled RBLs for which a borrower is unable to generate sufficient cash flow from oil and/or gas production to repay the loan (sometimes

5. For more information, see 17 CFR 210.4-10, "Financial accounting and reporting for oil and gas producing activities pursuant to the Federal securities laws and the Energy Policy and Conservation Act of 1975."

called "stretched" RBLs). A stretched RBL reflects a borrower with credit or liquidity weaknesses, and an institution should understand the fundamental causes of those weaknesses. An institution may still work with a troubled borrower to continue to service existing loans. An institution should confirm the reasons for the borrower's cash flow problems (for example, weaknesses in a borrower's financial condition or operations, or poor market conditions). An institution's credit administration process should appropriately monitor exposure to the borrower and adjust the credit facility rating to reflect the borrower's credit condition, as well as the viability of the borrower's operation, so that the institution can make an informed decision as to whether advancing additional funds is appropriate. Any additional funds advanced should be for the purpose of improving the borrower's financial condition.

Expectations for the level of sophistication of risk management systems will vary based on the specific risk characteristics, complexity, and size of an institution's reserve-based lending exposure. In general, there are higher expectations around risk management for banks with significant reserve-based lending exposures in concentrated geographic locations and market segments. An institution should assess the effect, if any, of its reserve-based lending activities on the institution's overall financial condition, including capital, the allowance for loan and lease losses, and liquidity.

TERMINOLOGY

The following are abbreviated explanations or discussions of some of the terms found in engineering reports and energy-lending transactions.

Analogy-based engineering data. Comparative analyses relating past performances of comparable properties to determine possible future reserves.

Assignment of production. Usually in the mortgage agreement, it allows direct payment from purchaser to the bank for oil production. Gas purchases generally are paid to the operator, and the operator then pays the bank.

Carried interest. When a party or parties have their expenses paid (carried) by other parties up to a specified limit.

Decline curves. Used to determine reserves by extrapolation of historical production data.

Deed of trust or mortgage. Covers real estate, surface rights, and mineral interests. Mortgage is unique because oil and gas are treated as real property while in the ground but converted to personal property interests as production is generated at the wellhead and as oil and gas enter storage tanks or a pipeline. The security agreement portion of the oil and gas mortgage will usually cover fixtures and equipment affixed to the well site.

Development wells. Drilled in the proven territory of a field, they have a high likelihood of producing oil or gas.

Division orders. Set out the borrower's interest in the property and direct production payments. Division order title opinions can be used to verify ownership and will contain the legal description of properties.

Escalating. Involves the difficult task of predicting future prices of oil and gas for valuing production. Escalating the value of production usually increases the risk to the lender. Examiners should carefully review the basis for escalating values when it has a significant impact on the value of the collateral and/or cash flow. Also, the examiner should carefully review how future expenses related to each well are estimated.

Exploratory well. Also known as a "wildcat," a well drilled in an unproven area. The term originated in early drilling days in Pennsylvania when wells were drilled within the sight and sound of wildcats.

Fault. A break or fracture in the earth's crust that causes rock layers to shift.

Field. An area in which a number of wells produce from a reservoir or from several reservoirs at various depths. There may be two or more reservoirs in a field that are separated vertically by intervening impermeable rock, laterally by local geologic barriers, or both.

Formation. A bed or deposit of substantially the same kinds of rocks.

Fracturing, frac'ing, frac job. Refers to pumping fluids under extremely high pressure into a formation to create or enlarge fractures through which oil or gas can move. Propping agents such as sand are sent down with fluids to hold the fractures open. Many completed wells require additional treatment (stimulation) before oil or gas can be produced.

Known accumulation. The term accumulation is used to identify an individual body of moveable petroleum in a reservoir. However, the key requirement is that in order to be considered as known, and hence contain reserves or contingent resources, each accumulation or reservoir must have been penetrated by a well. In general, the well must have clearly demonstrated the existence of moveable petroleum in that reservoir by flow to surface or at least some recovery of a sample of petroleum from the well. However, where log and/or core data exist, this may suffice, provided there is a good analogy to a nearby and geologically comparable known accumulation.

Lease. A contract between the landowner (lessor) and the lessee that gives the lessee the right to exploit the premises for minerals or other products and to use the surface as needed. However, surface damages would normally have to be reimbursed. Surface ownership is different from mineral ownership in many cases. Also, if drilling does not begin during a specified time period, the lease will expire.

Lithology. The scientific study of rocks.

Log(s). Used to record three basic measurements: electrical, radioactive, and sonic. The logging device is lowered into the well bore and transmits signals to the surface. These are recorded on film and used to make a log showing the recorded measurements that are used to analyze the formation's porosity, fluid saturation, and lithology. The log's header gives the log's type and date, the operator, the well name, and other information.

Market-out. A clause that basically allows the purchaser to stop paying the original contract price and institute a lower price with the intent of maintaining the marketability of the gas. Some contracts allow the producer to be released from the contract if he refuses the lower price or may offer other remedies.

Mineral rights. The ownership of minerals under a tract, which includes the right to explore, drill, and produce such minerals, or assign such rights in the form of a lease to another party. Mineral-rights ownership may or may not be severed from land-surface ownership, depending on state law. Title in fee simple means all rights are held by one owner; the fee in surface owner does not hold mineral rights. The term "minerals" is loosely used to refer to mineral ownership and even, incorrectly, to royalty ownership. A mineral acre is the full mineral interest under one acre of land.

Net revenue interest. A share of production after all burdens, such as royalty and overriding royalty, have been deducted from the working interest. It is the percentage of production that each party actually receives.

Operator. The manager of drilling and production for the owner.

Overriding royalty interest (ORRI). A royalty in excess of the royalty provided in the Oil & Gas Lease. Usually, an override is added during an intervening assignment. ORRIs are created out of the working interest in a property and do not affect mineral owners. An ORRI is a fractional, undivided interest with the right to participate or receive proceeds from the sale of oil and/or gas. It is not an interest in the minerals, but an interest in the proceeds or revenue from the oil & gas minerals sold. The interest is limited to a specific tract of land and is bound to the terms limits of the existing lease. If a lease is allowed to expire, an ORRI is dissolved or expires with the lease. Overrides expire and don't not continue into perpetuity in the same form as mineral or royalty interests.

Perforations. The holes in casing and cement through which oil and/or gas flow from formation into wellbore and up to surface.

Permeability. A measure of how easily fluids may flow through pore spaces. A tight rock or sand formation will have low permeability and, thus, low capacity to produce oil or gas. Wells in these zones usually require fracturing or other stimulation.

Porosity. Refers to the pore space in rock that enables it to hold fluids.

Proved developed shut-in (PDSI). Proved developed nonproducing reserves are subcategorized as nonproducing include proved developed shut-in (PDSI) and proved developed behind the pipe (PDBP) reserves. E&P companies expect to recover PDSI reserves from (1) completion intervals that are open at the time of the estimate but have not started producing, (2) wells that were shut-in for market conditions or pipeline connections, or (3) wells not capable of production for mechanical reasons.

Reservoir or pool. A subsurface rock formation containing an individual and separate natural accumulation of moveable petroleum that is confined by impermeable rock or by water barriers and is characterized by a single-pressure system.

Resource base or total petroleum initially-in-place. All estimated quantities of petroleum contained in the sub-surface, as well as those quantities already produced.

Reserves. The estimated amount of oil and gas in a given reservoir that is capable of being profitably recovered, assuming current costs, prices, and technology. Not to be confused with oil and gas in place (resource base), which is the total amount of petroleum in the earth regardless of whether or not it can be recovered. Recovery is a function not only of technology, but of the marketplace.

Reserve interest. The term used to describe the percent of revenue received.

Royalty interest. The share of gross production proceeds from a property received by its mineral owner(s), free of exploration, drilling, and production costs. Typically one-eighth to one-sixth of production, but fractions may be higher. Royalty payments take precedence over all other payments from lease revenues.

Primary, secondary, and tertiary recovery. Relates to the method of obtaining production from a well. Primary recovery is production from a reservoir through flowing or pumping wells because of the existence of natural energy within the reservoir. This usually recovers about 10 to 35 percent of the oil and gas in place. Secondary recovery is any method by which essentially depleted reservoir energy is restored. This may be accomplished by injection of liquids or gases or both. Tertiary recovery is any enhanced method employed after secondary recovery and is generally very costly.

Runs. A term used to refer to oil or gas production income from a lease.

Seismic survey or shooting. A method of gathering information by recording and analyzing shock waves artificially produced and reflected from subsurface rocks.

Shut-in well. A well that is capable of producing but is not presently operating. Reasons why a well may be shut in include lack of equipment or market.

Stripper wells. Wells that make less than 10 barrels of oil per day based on the last 12 months or wells that make less than 60,000 cubic feet of gas per day based on the last 90 days.

Volumetric calculations. Determine oil or gas reserves by use of rock volume and characteristics.

Working interest. Also referred to as an operating interest, the term used to describe the lease owner's interest in the well. Lease owners are the ones who pay for drilling and completing the well. Lease owners pay 100 percent of cost and receive all revenues after taxes and royalties are paid.

Workover. Relates to the process of cleaning out or other work on a well to restore or increase its production.

INTRODUCTION

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

The examiner must judge the quality of the asset-based credit by evaluating the financial condition and debt-servicing ability of the borrower and the quality of the collateral. In addition, the examiner must evaluate the bank's credit policy, internal controls, audit procedures, and operational practices.

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial bank loans may use asset-based loans to meet their financial needs. Some examples of asset-based borrowers are—

- businesses that are growing rapidly and need year-round financing in amounts too large to justify commercial lines of credit secured by blanket liens on accounts receivable and inventory,
- businesses that are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic cleanups,
- businesses whose working capital is inadequate for their volume of sales and type of operation, and
- businesses that cannot obtain regular commercial loan terms because of deteriorating credit factors.

Some advantages of asset-based lending for the borrower are—

- efficiency in financing an expanding operation because the business's borrowing capacity expands along with increases in levels of accounts receivables, inventory, and sales;
- the ability to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors in a timely manner (consistent usage of purchase discounts reduces the cost of goods sold and enhances the gross profit margin); and
- the interest paid on asset-based loans may be lower than for alternate sources of funds.

Some advantages of asset-based lending for banks are—

- a relatively high-yield loan is generated commensurate with the perceived credit risk of the borrower;
- a depository relationship is formed that provides income and enhances the bank's ability to monitor changes in the borrower's cash flow and overall financial condition;
- banking relationships with longstanding customers whose financial conditions no longer warrant traditional commercial bank loans can continue;
- new business is generated by prudently lending to financially weaker customers who could not qualify for normal commercial loans; and
- potential loss is minimized when the loan is collateralized by a percentage of the accounts receivable and inventory.

CREDIT ANALYSIS

Although asset-based loans are collateralized and closely monitored, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and supports the loan, the borrower should demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort. An examiner should analyze the borrower's financial statements with particular emphasis on trends in working capital, review trade reports, analyze accounts receivable and inventory turnover, and review the agings of receivables and payables. Furthermore, the prompt payment of taxes, especially payroll taxes, should be verified. One reason for a company to obtain asset-based financing is to maximize discounts offered by suppliers; therefore, it should pay creditors promptly upon receiving the financing.

Bank management's ability to recognize a customer's financial problems as they develop, and to initiate orderly liquidation, if necessary, is important in the supervision of asset-based financing. Theoretically, a borrower's line could be fully liquidated by discontinuing further advances, collecting the assigned receivables, and liquidating pledged inventory. However, such drastic action would most likely cause the borrower's business to close, resulting in a probable deterioration of the receivables from new disputes and in returns and offsets. Consequently, the bank usually notifies its borrower of a contemplated liquidation, which gives the borrower time to seek other means of continuing business so that the bank's loan may be liquidated in an orderly manner without losses or other adverse effects. Unless the bank has initiated an orderly liquidation, examiners should specially mention or classify receivable and inventory lines in which the borrower's financial position has declined so that continued financing is not prudent. When a liquidation is occurring, classification of the credit may not be necessary if the borrower's business is continuing, the existing collateral is of good quality, liquidation value sufficiently covers outstanding debt, and no collateral deterioration is anticipated.

A related issue concerning asset-based loans is the amount of excess availability associated with the revolving line of credit. The quantity of a borrowing company's excess availability is an excellent indicator of whether it has the capacity to service its loan. If a status report shows little availability, the borrower has used all of the cash that the pledged receivables and inventory are capable of generating under the asset-based line of credit. Since these loans may not yet be on the bank's watch list or problem-loan report, it is important for the examiner to track, over a fiscal-year period, a borrower's changing levels of availability when performing an analysis of creditworthiness. This analysis is especially critical for borrowers whose business is seasonal. Initial credit analyses of potential asset-based loan customers should include detailed projections showing that availability under revolving lines of credit at anticipated advance rates would be sufficient to meet the borrower's working-capital needs. Occasionally, overadvance lines are part of the initial credit facility.

Bank management must continually evaluate the realizable value of receivables and inventory pledged. To do so, management should review the quality of the receivables and inventory pledged, including documentation; the safeguards imposed to ensure the authenticity and collectibility of the assigned receivables; and the loan agreement and compliance therewith. The information obtained is sometimes difficult to interpret unless it is related to other periods, comparable businesses, or industry statistics. Comparative analysis helps indicate the continuing value of the collateral.

Lender-liability exposure is a risk in all types of commercial lending, but especially in asset-based lending. Borrowers using asset-based financing are generally very dependent on its continuation, so an abrupt cessation of a line of credit would be more likely to result in legal action against a lender. To protect themselves as much as possible from lender-liability lawsuits, banks frequently use time notes (with renewal options). Time notes are supported by loan agreements that usually include more numerous and detailed loan covenants. Legal counsels for both the lender and borrower should approve the loan agreement and covenants. At times, the borrower may not comply with one or more covenants in a loan agreement. The lender may agree to waive specific covenant violations to give a borrower time to take corrective action. If a covenant such as a financial covenant requiring a minimum capital level is waived, the waiver should be formally communicated to the borrower in writing. The lender should avoid both not taking action for a period of time and not issuing a written waiver for a covenant violation. In either case, if a covenant violation is subsequently used as a reason to cancel an asset-based loan, the lender is more vulnerable to lender liability. The lender should be careful to be consistent in all actions regarding the borrower.

ASSET-BASED LOAN AGREEMENTS

An asset-based loan agreement is a contract between a borrower and the bank that sets forth conditions governing the handling of the account and the remedies available in the event of default. The following areas should be addressed in the loan agreement:

- *Eligible accounts receivable.* This involves identifying classes of receivables that will not be regarded as acceptable collateral. Certain types of receivables carry a higher degree of risk relative to the willingness and ability of account debtors to pay and, by their very nature, should be excluded from the lending formula. The following are typical classes of ineligible receivables:

—*Delinquent accounts.* Eligible receivables generally exclude accounts that are more than a given number of days delinquent, most often 60 days or more past due. Delinquency is frequently expressed in loan agreements as a given number of days from the invoice date, such as 90 days from the invoice date when payment is required in 30 days, which is the most common payment term. Expressing delinquency in days from the invoice date prevents a borrower from reducing the volume of ineligible delinquent accounts by giving dated terms (extending payment days). For example, accounts with 30-day trade terms that are becoming 60 days delinquent could otherwise be maintained in the eligible-receivable base by increasing payment terms to 90 days. Also, under what is commonly referred to as the "50 percent rule," accounts with multiple invoices that have more than 50 percent of the total balance past due are excluded from the eligible-receivable base. For example, if a borrower's customer owes payment for ten invoices, of which six are delinquent, all ten would be considered ineligible, not just the six that are delinquent. While 50 percent is standard industry practice, lenders may be more conservative and require ineligibility for an entire account if less than 50 percent of it is past due.

—*Contra accounts.* These usually arise when the borrower both sells to and purchases from the account debtor. The risk is the possibility of direct offset against these accounts.

—*Affiliate accounts.* These accounts, unlike contra-accounts, occur when a borrower sells to an account debtor, both of whom are associated through common ownership. Associated risks include forgiveness of debt on behalf of the affiliate and a temptation for the borrower to create fraudulent invoices.

—*Concentration accounts.* A lender may be vulnerable to loss if a large percentage of the dollar amount of receivables assigned is concentrated in a few accounts. Too many sales, even to a good creditworthy customer, could ultimately cause problems should disputes arise over products or contracts. A common benchmark is that no more than 20 percent of the receivables assigned should be from one customer. Some lenders will use a percentage that is also subject to a dollar limit.

—*Bill-and-hold sales.* These occur when a product ordered by a buyer has actually been billed and is ready for shipment, but is held by the seller pending receipt of shipping instructions from the buyer. Bill-and-hold sales are not eligible as receivables to be loaned against because they are not fully executed transactions. A second party's claim could be of little value when merchandise has not been shipped and there is no evidence of acceptance on behalf of the buyer.

—*Progress billings.* These are invoices issued on partial completion of contracts, usually on a percentage basis. This practice is standard in construction and other industries where long-term contracts are generally used. Failure to complete a contract could jeopardize the collectibility of progress receivables and, therefore, should generally not be considered eligible collateral. Moreover, failure to complete contracts can expose companies to lawsuits from their customers, who may be forced to pay higher prices to other parties to complete the contracts over much shorter time periods. The only exception for progress billings is when, on partial completion, there has been delivery of the product, and the contract clearly states that buyers have accepted the product and are responsible for payment of the product delivered.

—*Receivables subject to a purchase-money interest.* These include floor-plan arrangements, under which a manufacturer will frequently file financing statements when merchandise is delivered to the borrower. That filing usually gives the manufacturer a superior lien on the receivable. An alternative would be to enter into an agreement with the manufacturer, which specifies that rights to the receivables are subordinated to the bank.

- *Percentage advanced against eligible or acceptable accounts receivable.* The accounts-receivable advance rate, typically in the range of 75 to 85 percent, must serve the two primary functions of providing adequate cash flow for the borrower and providing a margin that gives adequate protection for the lender. Protection for the lender requires a sufficient margin for the continual costs of collection and absorption of dilution in the receivables. Selecting the proper advance rate for a borrower involves understanding the amounts and causes of portfolio dilution. Causes of dilution that are positive include the offering of discounts and various allowances. Causes that are negative include merchandise returns, bad debts, product liability, or warranty claims. An abundance of negative causes, such as bad debts, might indicate poor receivable-management practices. A lender must know how dilution is occurring in each receivable portfolio to measure it continually. This knowledge should lead to proper advance-rate selection, resulting in a loan balance protected by a receivables base with sufficient liquidation value to repay the loan.

- *Percentage advanced against eligible inventory.* The inventory advance rate typically ranges from 35 to 65 percent for finished products. Marketability and accessibility of the inventory are key factors in determining the advance rate. Proper evaluation of the liquidation value of inventory requires a firm understanding of marketability in all the various inventory stages (raw materials, works-in-process, finished merchandise). Works-in-process often have very low marketability because of their unfinished nature, and they will typically carry a very low advance rate—if they are even allowed as eligible inventory. Conversely, the raw materials or commodities (such as aluminum ingots, bars, and rolls) have a broader marketability as separately financed collateral components. When setting advance rates, it is also important to consider whether inventory is valued at LIFO (last in, first out) or FIFO (first in, first out). In an inflationary environment, FIFO reporting will result in higher overall inventory values on the customer's books.

The above factors are considerations in the conduct of inventory audits performed in connection with the granting and monitoring of asset-based loans. These audits will generally discuss the inventory from a liquidation basis. This information is critical in determining appropriate advance rates.

Pledged Receivables

The following factors should be considered in evaluating the quality of receivables pledged:

- Standard procedures require that the bank obtain a monthly aging report of the accounts receivable pledged. The eligible receivables base is then calculated by deducting the various classes of ineligible receivables. Usually the eligible receivables base will be adjusted daily during the month following receipt of the aging report. If accounts are ledgered, the base will be increased by additional sales, as represented by duplicate copies of invoices together with shipping documents and/or delivery receipts received by the bank. The receivables base will be decreased daily by accounts-receivable payments received by the borrower, who then remits the payments to the bank. Another method of payment in which the bank has tighter control is a lockbox arrangement. Under this arrangement, receivables are pledged on a notification basis and the borrower's customers remit their payments on accounts receivable directly to the bank through deposit in a specially designated account. If accounts are not ledgered but a blanket assignment procedure is used, the borrower periodically informs the bank of the amount of receivables outstanding on its books. Based on this information, the bank advances the agreed percentage of the outstanding receivables. Receivables are also pledged on a non-notification basis, with payments on the receivables made directly to the borrower who then remits them to the bank. Proper management of any asset-based credit line requires that all payments on accounts receivable be remitted to the bank, with the accounts-receivable borrowing base reduced by a like amount. The borrower's working-capital needs should then be met by drawing against the asset-based credit line.
- Slower turnover of the pledged receivables can be a strong indication of deterioration in credit quality of accounts receivable.
- Debtor accounts that are significant to the bank borrower's business should be well rated and financially strong. Borrowers should also

obtain financial statements on their major customers to make credit decisions. These financial statements should be reviewed when the bank performs its periodic audits. In addition, the borrower should maintain an appropriate level of reserves for doubtful accounts. Credit insurance is often used, which indemnifies a company against noncollection of accounts receivable for credit reasons. When credit insurance is used, the asset-based lender should be named as beneficiary.
- Dilution or shrinking of the accounts-receivable borrowing base can result from disputes, returns, and offsets. A large or increasing volume of these transactions could adversely affect the bank's collateral position.

The following safeguards, which bank management should consider and the examiner should evaluate, ensure the authenticity and collectibility of the pledged accounts receivable:

- *Audits.* To verify the information supplied by the borrower to the bank, the bank should audit the borrower's books. Audits should occur several times a year at the borrower's place of business. For satisfactory borrowers, the audit is usually performed quarterly. However, audits can occur more frequently if deemed necessary. Individuals who perform bank audits should be independent of the credit function. The scope of an audit should include—
  - —verification that the information on the borrowing-base certificate reconciles to the borrower's books;
  - —review of concentrations of accounts;
  - —review of trends in accounts receivable, accounts payable, inventory, sales, and costs of goods sold;
  - —review of the control of cash proceeds;
  - —determination that the general ledger is regularly posted;
  - —verification of submitted aging reports;
  - —review of bank reconciliations and canceled checks;
  - —determination if any accounts receivable are being settled with notes receivable;
  - —verification that the accounts-receivable ledger is noted to show that an assignment has been made to the bank;
  - —determination on non-notification accounts that all payments are remitted to the bank and that positive written confirmations are issued timely (for example, semiannually);
  - —verification that all taxes, especially sales and payroll, are paid timely; and
  - —review of compliance with the loan agreement.
- *Confirmation.* To verify the authenticity of the pledged collateral, the bank should institute a program of direct confirmation. This procedure is particularly important if the accounts receivable are pledged on a non-notification basis, since the bank does not have the same control over debtor accounts as it does when the receivables are pledged on a notification basis. Direct confirmation should be made before the initial lending arrangement and periodically thereafter. Confirmation should be on a positive basis. The bank should obtain written approval from the borrower before confirming accounts receivable on a non-notification basis.

Pledged Inventory

The following factors should be considered in evaluating the inventory pledged:

- A borrowing-base certificate, obtained from the borrower at least monthly, is normally used to calculate the dollar amount of inventory eligible for collateral. The borrowing-base certificate will show the different classes of inventory, such as raw materials, works-in-process, and finished goods. After this will be listed the different types of ineligible inventory, which will be subtracted to give the amount of eligible inventory. Finally, the advance rates are applied to the different classes of eligible inventory to determine the borrowing base.
- Factors affecting marketability, advance rates, and the decision whether to allow a class of inventory as eligible at even a low advance rate:
  - —*Obsolescence.* This could involve not only merchandise that is no longer in demand for various reasons, such as technological advances, but also style products, such as clothing, which obviously have a greater potential for obsolescence.
  - —*Seasonal goods.* It is necessary to know the seasonal highs and lows associated with a particular class of inventory, as well as the costs associated with these seasonal variations.

—*Oversupply.* If there is an oversupply in the general market of a particular class of inventory, then its value would be negatively affected.

—*Limited-use raw materials and finished goods.* These would be difficult to liquidate at a reasonable value.

Two other areas a lender must analyze in setting the inventory advance rate are the ease or difficulty, in terms of cost, of liquidating inventory in multiple locations, and the cost of maintaining certain inventory, such as food products that require refrigeration, in a salable state.

In addition to marketability, accessibility of the collateral is extremely important, as liquidation plans become meaningless if a lender cannot gain access to collateral. Constant vigilance is necessary to guard against actions that would preempt a lender's security interest in inventory. Following are some common actions that impede a lender's access to collateral:

- *Possessory liens.* A landlord lien is a common example. To protect their interest, lenders need to obtain landlord waivers to the lien.
- *Nonpossessory liens.* A purchase-money security interest is a common example. These are usually filed by trade suppliers against their customers.
- *Secret lien.* A tax lien is the most common example. To ensure that a loss of collateral does not occur, it is necessary to conduct periodic lien searches if a borrower develops financial problems.

Commercial lenders often use outside appraisal firms to help them determine prudent inventory-advance rates. Also, normal industry practice for advance rates on different classes of inventory is available through the Commercial Finance Association Information Exchange.

Turnover rates should be analyzed to identify potential slow-moving or obsolete inventory, which should be subject to a lower or no advance rate. The borrower should establish inventory reserves if the volume of slow-moving or obsolete inventory is significant, and charge-off procedures should be in effect. Inventory should be adequately insured in relation to its location and amount. Furthermore, bill-and-hold merchandise and goods held on consignment should be physically segregated from other warehoused inventory and should not be included as inventory on the borrower's books or on the borrowing-base certificate submitted to the bank.

UCC Requirements for Secured Transactions

Article 9 of the UCC applies to any transaction that is intended to create a security interest in personal property. For a detailed discussion of the UCC requirements regarding secured transactions, refer to section 2080.1, "Commercial and Industrial Loans."

1. To determine if the policies, practices, procedures, and internal controls for accounts receivable and inventory financing are adequate.
2. To determine if bank officers are conforming to established guidelines.
3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with laws and regulations.
6. 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 asset-based lending section of the internal control questionnaire.
2. On the basis of the evaluation of internal controls and the work performed by internal or 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 deficiencies noted in the latest review done by internal or external auditors, and determine if corrections have been accomplished.
4. Obtain a trial balance of the customer liability records.
   a. Agree or reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination. Prepare credit line cards.
6. Obtain the following information from the bank or other examination areas, if applicable:
   a. past-due loans
   b. loans in a nonaccrual status
   c. loans on which interest is not being collected in accordance with the terms of the loan (Particular attention should be paid to loans that have been renewed without payment of interest.)
   d. loans whose terms have been modified by a reduction of interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of repayment terms
   e. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   f. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   g. loan commitments and other contingent liabilities
   h. Extensions of credit to employees, officers, directors, and principal shareholders and their interests, specifying which officers are considered executive officers
   i. extensions of credit to executive officers, directors, and principal shareholders and their interests of correspondent banks
   j. a list of correspondent banks
   k. miscellaneous loan-debit and credit-suspense accounts
   l. loans considered "problem loans" by management
   m. Shared National Credits
   n. specific guidelines in the lending policy
   o. each officer's current lending authority
   p. current interest-rate structure
   q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
   r. reports furnished to the loan and discount committee or any similar committee
   s. reports furnished to the board of directors
   t. loans classified during the preceding examination
7. Review the information received and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
      - Participations only:
        - — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
        - — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        - — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      - Procedures pertaining to *all* transfers:
        - — Investigate any situations in which loans were transferred immediately before the date of examination to determine if any were transferred

to avoid possible criticism during the examination.

— Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.
— Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans. (While fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on these loans as well as an appropriate risk premium.) Section 23A of the Federal Reserve Act prohibits a state member bank from purchasing a low-quality asset.
— Determine that low-quality loans transferred to an affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.
— If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:
  (1) name of originating institution
  (2) name of receiving institution
  (3) type of transfer (i.e., participation, purchase or sale, swap)
  (4) date of transfer
  (5) total number of loans transferred
  (6) total dollar amount of loans transferred
  (7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
  (8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
  • Discuss with management any large or old items.
  • Perform additional procedures as deemed appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability if the borrower has been advised of the commitment, and analyze the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeding the cutoff.

d. *Loans classified during the previous examination.*
  • Determine the disposition of loans so classified by transcribing—
    — current balance and payment status, or
    — date loan was repaid and source of payment.
  • Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank, or as a result of a participation, sale, or swap with another lending institution. If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.

e. *Uniform review of Shared National Credits.*
  • Compare the schedule of credits included in the uniform review of Shared National Credits Program with line cards to ascertain which loans in the sample are portions of Shared National Credits.
  • For each loan so identified, transcribe appropriate information from schedule to line cards. (No further examination procedures are necessary in this area.)

8. Consult with the examiner responsible for the asset/liability management analysis to determine the appropriate maturity breakdown of loans needed for the analysis. If requested, compile the information using bank records or other appropriate sources. See "Instructions for the Report of Examination," section 6000.1, for the considerations to be taken into account when compiling maturity information for the gap analysis.

9. Prepare line cards for any loan not in the sample that, on the basis of the information derived from the above schedules, requires in-depth review.
10. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, lease financing, and other loan areas, and together decide who will review the borrowing relationship.
11. Obtain credit files for each loan for which line cards have been prepared. In analyzing the loans, perform the following procedures:
    a. Analyze balance-sheet and profit-and-loss items as reflected in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information and consolidation techniques for major balance-sheet items.
    d. Ascertain compliance with provisions of loan agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence.
    f. Review the following:
        - relationship between amount collected in a month on the receivables pledged as collateral and the borrower's credit limit
        - aging of accounts receivable
        - ineligible receivables
        - concentration of debtor accounts
        - financial strength of debtor accounts
        - disputes, returns, and offsets
        - management's safeguards to ensure the authenticity and collectibility of the assigned receivables
    g. Analyze secondary support offered by guarantors and endorsers.
    h. Ascertain compliance with established bank policy.
12. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
13. Determine compliance with laws and regulations pertaining to accounts receivable lending by performing the following steps.
    a. *Lending limits.*
        - Determine the bank's lending limit as prescribed by state law.
        - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and Regulation W.*
        - Obtain a listing of loans to affiliates.
        - Compare the listing with the bank's customer liability records to determine its accuracy and completeness.
        - Obtain a listing of other covered transactions with affiliates (i.e., acceptance of affiliate's securities as collateral for a loan to any person).
        - Ensure that covered transactions with affiliates do not exceed the limits of section 23A and Regulation W.
        - Ensure that covered transactions with affiliates meet the collateral requirements of section 23A and Regulation W.
        - Determine that low-quality loans have not been purchased from an affiliate.
        - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
        - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
        - While examining the accounts receivable loan area, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
        - Investigate any such suspected situation.
    d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
        - While examining the accounts receivable loan area, determine the existence

of any loans in connection with any political campaign.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and regulations and in the ordinary course of business.

e. *12 USC 1972, Tie-In Provisions.* While examining the accounts receivable loan area, determine whether any extension of credit is conditioned upon—
- obtaining or providing an additional credit, property, or service to or from the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
- the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows. (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders that is received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
  - — test the accuracy and completeness of information about accounts receivable loans by comparing it with the trial balance or loans sampled;
  - — review credit files on insider loans to determine that required information is available;
  - — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
  - — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
  - — determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
  - — if prior approval by the bank's board was required for a loan to an insider, determine that this approval was obtained;
  - — determine compliance with the various reporting requirements for insider loans;
  - — determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
  - — determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  - — Obtain from or request that the examiners reviewing due from banks and deposit accounts verify a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  - — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions (31 CFR 103.33), Retention of Credit Files.* Review the operating procedures and credit file documentation and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.)

14. Determine whether the consumer compliance examination uncovered any violations

of law or regulation in this department. If violations were noted, determine whether corrective action was taken. Extend testing to determine subsequent compliance with any noted law or regulation.

15. Perform the appropriate steps in “Concentrations of Credits,” section 2050.3.
16. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans
    b. loans not supported by current and complete financial information
    c. loans on which documentation is deficient
    d. inadequately collateralized loans
    e. classified loans
    f. Small Business Administration delinquent or criticized loans
    g. transfers of low-quality loans to or from another lending institution
    h. concentrations of credit
    i. extensions of credit to major shareholders, employees, officers, directors, and/or their interests
    j. violations of laws and regulations
    k. other matters concerning the condition of the department
17. Evaluate the function for—
    a. the adequacy of written policies, relating to accounts receivable financing;
    b. the manner in which bank officers are conforming with established policy;
    c. adverse trends within the accounts receivable financing department;
    d. the accuracy and completeness of the schedules obtained from the bank;
    e. internal control deficiencies or exceptions;
    f. recommended corrective action when policies, practices, or procedures are deficient;
    g. the competency of departmental management; and
    h. other matters of significance.
18. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for making and servicing accounts receivable financing loans. The bank's system should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

POLICIES

*1. Has the board of directors, consistent with its duties and responsibilities, adopted written accounts receivable financing policies that—
   a. establish procedures for reviewing accounts receivable financing applications,
   b. establish standards for determining credit lines,
   c. establish standards for determining percentage advance to be made against acceptable receivables,
   d. define acceptable receivables,
   e. establish minimum requirements for verification of borrower's accounts receivable, and
   f. establish minimum standards for documentation?
2. Are accounts receivable financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary accounts receivable financing records performed or reviewed by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?
*4. Are the subsidiary accounts receivable financing records reconciled, at least monthly, to the appropriate general ledger accounts, and are reconciling items investigated by persons who do not also handle cash?
5. Are loan statements, delinquent account collection requests, and past-due notices checked to the trial balances that are used in reconciling subsidiary records of accounts receivable financing loans with general ledger accounts, and are they handled only by persons who do not also handle cash?
6. Are inquiries about accounts receivable financing loan balances received and investigated by persons who do not also handle cash or pass adjustments?
*7. Are documents supporting recorded credit adjustments to loan accounts or accrued interest receivable accounts checked or tested subsequently by persons who do not also handle cash or initiate transactions (if so, explain briefly)?
8. Are terms, dates, weights, descriptions of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences?
9. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
10. Are payments from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

*11. Is the preparation and posting of loan interest records performed or reviewed by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?
12. Are independent interest computations made and compared or tested to initial loan interest records by persons who do not also—
   a. issue official checks and drafts or
   b. handle cash?

COLLATERAL

*13. Does the bank record, on a timely basis, a first lien on the assigned receivables for each borrower?
14. Do all loans granted on the security of the receivables also have an assignment of the inventory?

15. Does the bank verify the borrower's accounts receivable or require independent verification periodically?
16. Does the bank require the borrower to provide aged accounts receivable schedules periodically?
17. If applicable, are cash receipts and invoices block proven in the mailroom and subsequently traced to posting on daily transaction records?

CONCLUSION

18. 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.
19. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Some member banks provide lending services to stock brokerage firms using marketable securities as collateral. While various financial services are offered, typically most banks make loans to brokerage firms to provide them with the funding needed to carry their securities portfolio. The securities can either be held by the bank or a tri-party custodian or pledged to the bank at a depository. Collateral securities can be in physical form or can be held at a depository in book-entry form.

To promote efficiency, a brokerage firm may use a depository to hold the securities it has pledged as collateral for a bank loan. Brokerage firms deposit shares of eligible securities with the depository, and the stock certificates representing those shares are registered in the name of a common nominee. Beneficial ownership of the securities is transferred through computerized book entries, thus eliminating the physical movement of the securities. The depository has physical control of the securities while they are on deposit. Loan arrangements are made between the broker and the lending bank, with the broker providing electronic instructions to the depository to debit the firm's account and credit that of the lending bank. The depository acknowledges the transaction to the lending bank and will not reverse the entry or allow partial withdrawals without authorization from that institution. Participating banks receive daily reports showing their position in the program by broker name and type of security.

The New York Stock Exchange formed a subsidiary, the National Securities Clearing Corporation (NSCC), to provide equity clearance and continuous net settlement for the brokerage community. The Depository Trust Company in New York, under contract with the NSCC, handles the technical aspects of that operation, including final settlement. Collateral-pledging services may be offered by other depositories as well.

Book-entry transfer of ownership is limited to only those securities that are eligible for deposit in a depository. However, even if a security was depository-eligible, it would not be eligible for book-entry movement unless the lending bank was a direct or indirect participant in the depository. If the lending institution does not have a relationship, either directly or indirectly, with a depository, the securities would have to be delivered physically to the ultimate custodian (presumably the lending bank).

Securities lending is not always constrained by eligibility. Depending on the bank's underwriting standards, some banks may be willing to lend on the basis of securities that are not depository-eligible. This would preclude book-entry movement and require physical delivery.

1. To determine if policies, practices, procedures, objectives, and internal controls for securities broker and dealer loans are adequate.
2. To determine the types of loans (underwriting loan, day loan, inventory loan, margin loan, or guidance line) made, loan pricing and fees, loan-to-value ratios, and margin calls.
3. To evaluate credit quality, credit analysis, collateral and custody requirements, and procedures for lost and stolen securities.
4. To determine if bank officers are operating in conformance with the established guidelines.
5. To determine compliance with applicable laws and regulations, including Regulations T and U, the Securities Act of 1933, and the Securities Exchange Act of 1934.
6. To evaluate management information systems, particularly the lender's ability to ensure adequate collateral coverage by being able to automatically price collateral daily.
7. To determine the scope and adequacy of the audit function.
8. To initiate corrective action when policies, practices, procedures, objectives, or internal controls are deficient or when violations of laws or regulations have been noted.

1. If selected for implementation, complete or update the Securities Broker and Dealer Loans section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and of the work performed by internal/external auditors ascertain 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 deficiencies noted in the latest review done by internal/external auditors, and determine if corrections have been accomplished.
4. Request the bank to supply:
   a. Schedule of approved lines for each dealer including outstanding balances.
   b. Delinquent interest billings, date billed amount of past-due interest.
5. Obtain a trial balance of all dealer accounts and:
   a. Agree balances to department controls and general ledger.
   b. Review reconciling items for reasonableness.
6. Using an appropriate technique, select borrowers to be reviewed.
7. Using the trial balance, transcribe the following information for each borrower selected onto the credit line cards.
   a. Total outstanding liability.
   b. Amount of approved line.
8. Obtain from the appropriate examiner the following schedules, if applicable to this area:
   a. Past-due loans.
   b. Loan commitments and other contingent liabilities.
   c. Miscellaneous loan debit and credit suspense accounts.
   d. Loans considered "problem loans" by management.
   e. Each officer's current lending authority.
   f. Current interest rate structure.
   g. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee.
   h. Reports furnished to the loan and discount committee or any similar committee.
   i. Reports furnished to the board of directors.
   j. Loans classified during the preceding examination.
   k. A listing of loans charged-off since the preceding examination.
9. Review the information received and perform the following:
   a. For miscellaneous loan debit and credit suspense accounts:
      - Discuss with management any large or old items.
      - Perform additional procedures as deemed appropriate.
   b. For loans classified during the previous examination, determine disposition of loans so classified by transcribing:
      - Current balances and payment status, *or*
      - Date loan was repaid and sources of payment.
   c. For loan commitments and other contingent liabilities, analyze if:
      - The borrower has been advised of the contingent liability.
      - The combined amounts of the current loan balance and the commitment or contingent liability exceed the cutoff.
   d. Select loans which require in-depth review based on information derived when performing the above steps.
10. For those loans selected in step 6 above and for any other loans selected while performing the above steps, transcribe the following information from the bank's collateral record onto the credit-line cards:
    a. A list of collateral held, including date of entry, and amount advanced.
    b. A brief of the agreement between the bank and the dealer.
    c. Evidence that the proper documentation is in place.
    d. Details of any other collateral held.
11. The examiner should be aware that certain stock-secured purpose transactions with and for brokers and dealers are exempt from the

margin restrictions of Regulation U. Refer to the regulation for a complete description of such transactions, which include the following:
   a. Temporary advances to finance cash transactions.
   b. Securities in transit or transfer.
   c. Day loans.
   d. Temporary financing of distributions.
   e. Arbitrage transactions.
   f. Credit extended pursuant to hypothecation.
   g. Emergency credit.
   h. Loans to specialists.
   i. Loans to odd-lot dealers.
   j. Loans to OTC market makers.
   k. Loans to third-market makers
   l. Loans to block positioners.
   m. Loans for capital contributions.
12. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
   a. Delinquent loans, including a breakout of "A" paper.
   b. Loans on which collateral documentation is deficient.
   c. Recommended corrective action when policies, practices or procedures are deficient.
   d. Other matters regarding the condition of the department.
13. Prepare appropriate comments for examination report stating your findings with regard to:
   a. The adequacy of written policies relating to dealer loans.
   b. The manner in which bank officers are conforming with established policy.
   c. Schedules applicable to the department that were discovered to be incorrect or incomplete.
   d. The competence of departmental management.
   e. Internal control deficiencies or exceptions.
   f. Other matters of significance.
14. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal control, policies, practices and procedures for making and servicing loans. 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.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written loan policies that:

    a. Establish standards for determining broker and dealer credit lines?

    b. Establish minimum standards for documentation?

2. Are such loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

3. Is a daily record maintained summarizing loan transaction details, i.e., loans made, payments received and interest collected to support applicable general ledger account entries?

4. Are frequent note and liability ledger trial balances prepared and reconciled with controlling accounts by employees who do not process or record loan transactions?

5. Is an exception report produced and reviewed by operating management that encompasses extensions, renewals or any factors that would result in a change in customer account status?

6. Do customer account records clearly indicate accounts which have been renewed or extended?

LOAN INTEREST

7. Is the preparation and posting of interest records performed and reviewed by appropriate personnel?
8. Are any independent interest computations made and compared or adequately tested to initial interest records by appropriate personnel?

COLLATERAL

9. Are multicopy, prenumbered records maintained that:
    a. Detail the complete description of collateral pledged?
    b. Are typed or completed in ink?
10. Are receipts issued to customers covering each item of negotiable collateral deposited?
11. If applicable, are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
12. Are appropriate steps with regard to Regulation U being considered in granting dealer and broker loans?

CONCLUSION

13. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant deficienicies in areas not covered in this questionnaire that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
14. Based on composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Factoring is the purchase, essentially without recourse, of the accounts receivable of a client by a bank (the factor). Generally, factor clients are small, undercapitalized companies or start-up firms with limited liquidity that generally do not qualify for more traditional bank financing. In contrast to accounts receivable financing, where the client retains the credit and collection risk associated with the receivables, factoring transfers these risks to the factor. For the client, the principal advantage of factoring is the assurance that it will receive the proceeds of its sales, regardless of whether the factor is paid. Furthermore, the client does not have to maintain a credit department to evaluate the creditworthiness of customers, collect past-due accounts, or maintain accounting records on the status of receivables. The factor assumes these responsibilities. An additional advantage for the client is that under the terms of an ''advance factoring'' arrangement, the client receives payment for its receivables before the time stated on the invoice.

Two basic types of factoring service offered by the industry are (1) maturity factoring and (2) advance factoring. In maturity factoring, an average maturity due date is computed for the receivables purchased within a given time period, and the client receives payment on that date. Advance factoring is computed in the same way; however, the client has the option of taking a percentage of the balance due on a receivable in advance of the computed average maturity due date. The remainder of the receivable, sometimes called the ''client's equity,'' is payable on demand at the due date.

ACCOUNTING FOR FACTORING

The factor's balance sheet reflects the purchased accounts receivable as an asset account, ''factored receivables,'' with ''due to clients'' as the corresponding liability. Usually, the balance of due-to-clients will be less than the factored receivables because of payments and advances to the clients. If, however, the factor makes advances to the client in amounts that exceed amounts due to the client, the advances will be shown as ''overadvances.'' Overadvances are common and usually secured by other collateral. The factoring agreement should set limits on the amount of overadvances available at any one time, generally based on specified collateral, such as the client's inventory. The relationship to inventory is based on the premise that the inventory will be sold, thus generating receivables that the factor has contracted to purchase. Proceeds from the factored receivables resulting from the sale of inventory are then used to repay the overadvance. If the overadvance is unsecured, it should be offset by a corresponding reduction in the ''client's equity.'' The factor's income statement will show factoring commissions, which represent the discount on the receivables purchased, as income. Interest income for advances on the due-to-client balances may or may not be a separate line item.

Since factoring is a highly competitive industry, price cutting has reduced factoring commissions to the point that they provide minimal support to a factor's earnings. As a result, interest margins on factoring advances represent an increasingly important part of a factor's net income. An analysis of proportional changes in the due-to-clients account should provide valuable insight into the analysis of the earnings of a bank's factoring activities. As more clients take advances (reducing due-to-clients), profit margins should widen. Conversely, as the due-to-clients proportion of total liabilities rises, profit margins may be expected to narrow.

FACTORING AGREEMENT, APPROVAL PROCEDURES, AND EXAMINER'S EVALUATION

The typical factoring agreement stipulates that all of a client's accounts receivable are assigned to the factor. However, the agreement between the factor and the client will usually state that receivables subject to shipping disputes and errors, returns, and adjustments are chargeable back to the client because they do not represent bona fide sales. The agreement will, in most instances, require that a reserve be established against the purchased receivables to ensure the factor's access to funds for any future chargeback adjustments.

The usual approval process requires the client to contact the factor's credit department before filling a sales order on credit terms. The credit department conducts a credit review, determines the creditworthiness of the customer, and approves or rejects the sale. If the credit department rejects the sale, the client may complete the sale, but at its own risk. The most commonly rejected sales are those to affiliates, known bad risks, customers whose credit cannot be verified, and customers whose outstanding payables exceed the factor's credit line to that customer. Sales made by the client without the factor's approval are considered client-risk receivables, and the factor has full recourse to the client.

Once a sale has been made and the receivable assigned to the factor, whether or not the factor has approved it, the client's account will be credited for the net invoice amount of the sale. Trade or volume discounts, early payment terms, and other adjustments are deducted from the invoice amount. The receivable then becomes part of the client's "availability" to be paid immediately or at the computed date, depending on the basis of the factoring arrangement.

Each month the client receives an "accounts-current" statement from the factor, which details daily transactions. This statement reflects the daily assignments of receivables, remittances made (including overadvances and amounts advanced at the client's risk), deductions for term loans, interest charges, and factoring commissions. Credit memos, client-risk charge-backs, and other adjustments will also be shown. Client-risk charge-backs are the amounts deducted from the remittances to the client resulting from the failure of the client's customers to pay receivables that were advanced at the client's risk.

The accounts-current statement and the availability sheets are necessary for analyzing asset quality. The factor's ability to generate these reports daily is a basic control feature. Accounting systems for a high-volume operation probably will be automated, providing the factor with the data necessary to properly monitor the client. If a monitoring system is in place, the examiner should use the data provided in the asset analysis process.

The evaluation of a factoring operation includes a review of its systems and controls as well as an analysis of the quality of its assets. A major portion of a factor's assets will be factored receivables, for which the credit department has the responsibility for credit quality and collection. The other major portion of assets will consist of client loans and credit accommodations, such as overadvances and amounts advanced at the client's risk, for which the account officers are responsible.

CREDIT DEPARTMENT EVALUATION

Because of its integral function in the credit and collection process, the credit department is the heart of a factoring operation. The department should maintain a credit file for each of its client's customers, and these files should be continually updated as purchases are made and paid for by the customers. These files should include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Each customer should have an assigned credit line based on the credit department's review of the customer's credit capacity.

The objective of a credit department evaluation is to critique the credit and collection process and to assess departmental effectiveness. The examiner should have a copy of departmental policies and procedures as well as a verbal understanding of them before beginning the review. The factor's policies should include, at a minimum, well-defined field audit procedures, a fraud detection and monitoring plan, and a computer back-up plan. Customer files selected for review may be drawn from large and closely monitored customers, or they may be selected by a random sample.

ASSET EVALUATION

The asset evaluation is a twofold process. The first part is to evaluate credit accommodations to each client. The second part is to evaluate customer receivables purchased by the factor at its own risk. For the first part of the process, the examiner should obtain a list that shows the aggregate of each client's credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. For the second part of the process, the examiner should obtain an aging schedule of factored receivables aggregated by customer but net of client-risk receivables. The selection of clients and customers for review should be based on the same selection methods as those used for the commercial loan review. Clients with a high "dilution" of receivables (that is, customer nonpayment due to returns, shipping disputes, or errors) and those with client-risk receivables equal to 20 percent or more of factored volume might also be selected for review. Past-due factored volume is not a meaningful measure of client quality because a factor usually collects principal and interest payments directly from the client's availability.

A maturity client's availability is the sum of all factored receivables less trade and other discounts, factoring commissions, client-risk charge-backs, and other miscellaneous charges to the client's account. There may also be deductions for letters of credit and other credit accommodations. An advance client's availability would be further reduced by advances on the factored receivables, interest charges, and the reciprocal of the contractually agreed-upon "advance" percentage. This reciprocal, 20 percent in the case of a client who receives an 80 percent advance, is sometimes referred to as the client's equity in the factored receivables. Availability may be increased by liens on additional collateral, such as inventory, machinery and equipment, real estate, and other marketable assets.

A client's balance sheet will show a "due-from-factor" account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, thus distorting turnover ratios and other short-term ratios. A client can convert sales to cash faster with a factor than if it collected the receivables. The statement analysis should consider the client's ability to repay any advances received from the factor in the form of overadvances, term loans, or other credit accommodations. The analysis should also assess the client's ability to absorb normal dilution and the potential losses associated with client-risk receivables, particularly when these elements are unusually high.

CLASSIFICATION GUIDELINES

When classifying the credit exposure to a client, the client-risk receivables portion of factored volume is the only amount subject to classification. Because of the recourse aspect, the balance is considered an indirect obligation rather than a direct obligation. Any other credit accommodations to a client that are not included in factored receivables, such as overadvances or term loans, are also subject to classification. Customer receivables purchased by the factor at its own risk are subject to classification. Care should be taken not to classify any receivables that have already been classified under client-risk exposure. Seasonal aspects of clients' businesses should be carefully analyzed in assessing asset quality based on classification data.

CONCLUSION

Due to the large volume of daily transactions that typically flows through a factor, any internal control procedure that can be easily circumvented is a potential problem. The review of the department's internal systems and controls should be continuous throughout the examination. This review should include credit controls for both clients and customers. Since credit problems can develop rapidly in factoring, credit controls and systems must be responsive to the identification of these problems. Earnings and capital adequacy are evaluated based on the department's own performance. The factoring department's earnings trends may be evaluated by comparing the yield on assets for various periods. Factors are subject to the same price competition in the commercial finance market as accounts receivable financiers. Declining portfolio yields may reflect competitive pressures and may portend declining future profitability.

1. To determine if policies, practices, procedures, and internal controls for factoring are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for performance, credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. 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 Factoring section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by 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 deficiencies noted in the latest reviews done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance(s) of applicable asset and liability accounts and:
   a. Agree or reconcile balances to department controls and general ledger.
   b. Review reconciling items for reasonableness.
5. Obtain the following information:
   a. A list of all clients with their outstanding balances including total factored receivables with those purchased at the client's risk segregated, overadvances, term loans and other credit accommodations.
   b. If not included in 5a above, a list of amounts due to each client by the factor (availability reports).
   c. Aging schedules of factored receivables by client and by customer with client risk receivables segregated.
   d. Past due status reports for 5c, above.
   e. Listings of all clients and customers considered to be problems.
   f. Credits classified at the previous examination.
   g. Concentration reports by client and by customer.
   h. Exception reports highlighting dilution of factored receivables because of shipping disputes and errors, returns, or any other adjustments.
   i. Credit commitments/lines for each client including amounts for overadvances and receivables purchased at the client's risk.
   j. Credit lines for each customer.
   k. Specific lending policy guidelines including each officer's current lending authority.
   l. Current fee schedule.
   m. Any useful information obtained from the review of the minutes of the loan and discount committee or any similar committees.
   n. Reports furnished to the board of directors.
   o. Any other management reports maintained by the factoring department.
6. After consulting with the examiner-in-charge, determine the appropriate cut-off lines for:
   a. Client's aggregate direct liability (i.e., overadvances, term loans and other credit accommodations).
   b. Client's indirect liability (i.e., client-risk exposure).
   c. Customer's factored receivables not including those in 6b above.
7. Transcribe information to line cards for all client and customer credits over the cut-off limits, for all credits recognized as problems, and for credits classified at the previous examination.
8. Cross reference clients and customers with the examiners assigned to other loan areas for common borrowers, and together decide who will review the borrowing relationship.
9. Obtain credit files for all clients and customers for whom line cards were prepared and analyze the accounts by performing the following procedures:
   a. Analyze balance sheet and profit and loss items as reflected in current and preceding financial statements, determine the existence of any favorable or adverse trends.
   b. Review components of the balance sheet as reflected in the current financial statements and determine the reasonableness of each item as its relates to the total financial structure.
   c. Review supporting information for the major balance sheet items and the techniques used in consolidation, if applicable, and determine the primary sources of repayment and evaluate their adequacy.
   d. Compare the amount of the credit line(s) with the lending officer's authority.
   e. Determine compliance with the bank's established commercial loan policy.

In addition to the above procedures which are applicable to both client and customer accounts, the following additional procedures should be performed for client accounts only:

f. Determine compliance with provisions of factoring agreements.
g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual program as set forth in the factoring agreement.
h. Relate collateral values to outstanding debt.
i. Compare fees charged to the fee schedule and determine that the terms are within established guidelines.
j. Analyze secondary support afforded by guarantors and endorsers.

10. Perform appropriate procedural steps in Concentration of Credits section, if applicable.
11. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Delinquent amounts, segregating those considered "A" paper.
    b. Violations of laws and regulations.
    c. Accounts not supported by current and complete financial information or on which other documentation is deficient.
    d. Concentrations of credit.
    e. Criticized accounts.
    f. Other matters regarding condition of asset quality.
12. Evaluate the factoring department with respect to:
    a. The adequacy of written policies relating to factoring.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the factoring department.
    d. Internal control deficiences or exceptions.
    e. Recommended corrective action when policies, practices or procedures are deficient.
    f. The competency of departmental management.
    g. Other matters of significance.
13. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for its factoring operation. 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.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written factoring policies that:
   a. Establish procedures for reviewing factoring agreements?
   b. Establish standards for determining client credit lines for each of the various types of accommodations available (i.e., factored receivables, client-risk receivables, overadvances, term loans, etc.)?
   c. Establish standards for determining individual customer limits?
   d. Require a client to contact the factor for approval before filling a sales order on credit terms?
   e. Establish standards for approving the sales orders referred to above.
   f. Establish standards for determining the percentage of advance that will be made against acceptable receivables in advance factoring arrangements?
   g. Establish standards for determining the discount on factored receivables and the interest rate or fee charged for other credit accommodations?
   h. Establish minimum standards for documentation?
2. Are factoring policies reviewed at least annually to determine if they are compatible with changing market conditions?

INTERNAL CONTROL

*3. Is the preparation and posting of subsidiary factoring records performed or reviewed by persons who do not also:
   a. Issue official checks and drafts?
   b. Handle cash?

*4. Are the subsidiary factoring records reconciled, at least monthly, to the appropriate general ledger accounts, and reconciling items investigated by persons who do not also handle cash?

5. Are accounts current statements, delinquent account collection requests, and past-due notices checked to the trial balances that are used in reconciling subsidiary records of factoring accounts with general ledger accounts, *and* handled only by persons who do not also handle cash?
6. Are inquiries about factored balances received and investigated by persons who do not also handle cash?

*7. Are documents supporting recorded credit adjustments to factored receivable accounts and the due-to-clients accounts checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?

8. Are proper records maintained for approval of:
   a. Customer orders?
   b. Client credit accommodations?
9. Are items, dates, weights, description of merchandise, etc., shown on invoices, shipping documents, delivery receipts, and bills of lading scrutinized for differences?
10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
11. Are payments from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

INTEREST AND FEES

*12. Is the preparation and posting of discount, interest, and fee records performed or reviewed by persons who do not also:
   a. Issue official checks and drafts singly?
   b. Handle cash?

13. Are independent discount, interest and fee computations made and compared or tested to initial records by persons who do not also:
   a. Issue official checks and drafts?
   b. Handle cash?

COLLATERAL

*14. Does the bank record, on a timely basis, a first lien on the assigned receivables for each borrower?

15. Does the bank verify the borrower's accounts receivable or require independent verification on a periodic basis?

16. Does the bank review aged accounts receivable schedules on a regular basis?

17. If applicable, are cash receipts and invoices block proved in the mailroom and subsequently traced to posting on daily transaction records?

CONCLUSION

18. 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.

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

OTHER ASSETS

The term *other assets,* as used in this section, includes all balance-sheet asset accounts not covered specifically in other areas of the examination. Often, such accounts may be quite insignificant in the overall financial condition of the bank. However, significant subquality assets may be uncovered in banks lacking proper internal controls and procedures.

In many banks, other asset accounts are maintained on the daily statement but must be reflected in a specific asset category for reporting. Schedule RC-F of the Consolidated Report of Condition lists the specific accounts classified as "other assets" and includes a catchall heading of "other." Certain accounts in that other asset account, such as securities borrowed, are examined using the procedures described in the appropriate section of this manual.

Types of Other Asset Accounts

Types of other assets frequently found in banks are the various temporary holding accounts, such as suspense, interoffice, teller, transit, and bookkeeping differences having debit balances. Those accounts should be used only for temporary recording until the offsetting entry is received or fully identified and posted to the proper account. A bank should have written internal control procedures to ensure that difference accounts are reconciled and closed out on a timely basis. Nothing should be allowed to remain in those accounts for any significant length of time—usually no more than a few business days. All difference accounts should be closed out at least quarterly.

General categories of other assets common to banks are accrued interest receivables (on loans, debt securities, and other interest-bearing assets) and other types of income earned but not yet collected (income derived from an asset that is recognized but not yet collected or received on the reporting date), net deferred tax assets (deferred tax assets less deferred tax liabilities that result in a debit balance for a particular tax jurisdiction), interest-only strips receivables for mortgage loans and other financial assets, prepaid expenses (cash outlays for goods and services, the benefits of which will be realized in future periods), equity securities (cost of) that do not have readily determinable fair values (including Federal Reserve stock and bankers' bank stock), the cash surrender value of bank-owned life insurance (BOLI), and other nonsecurity or other interest-only strips receivables.

An interest-only strip receivable is the contractual right to receive some or all of the interest due on a bond, mortgage loan, collateralized mortgage obligation, or other interest-bearing financial asset. This includes, for example, the contractual rights to future interest cash flows that exceed contractually specified servicing fees on financial assets that have been sold.

The other assets category also consists of unique and unusual transactions that are not appropriate to include in other line items of a bank's balance sheet. An unlimited number of possible account titles could be included in this category, such as redeemed food stamps, art objects, antiques, and coin and bullion. Regardless, the examiner must design specific procedures for review and testing to fit the particular account and situation and must document the scope of the review in the workpapers.

Examination Review of Other Assets

Examiners assigned to "other assets" must obtain the detailed breakdown of these accounts when they are reported on the bank's statement of condition and when they are so designated for the purposes of reporting on the bank's Call Report. When the account can best be examined by examiners assigned to other areas of the bank, the detailed breakdown of the accounts should be furnished to those examiners. The remaining accounts should be reviewed and evaluated by examiners assigned to this section. The major factor in deciding which accounts are to be reviewed are materiality and the volume of transactions flowing through the account.

With regard to materiality, the examiner should evaluate whether to analyze the nature and quality of each individual item, on the basis of its impact on the overall soundness of the bank or the quality of the bank's earnings. Therefore, the examiner needs to verify—

- the existence of the asset;
- the proper valuation of the asset;

- that the asset is properly classified, described, and disclosed in the financial statements (including the existence of any liens);
- that the asset is being properly amortized on a consistent basis over the estimated period of benefit;
- that any sales of assets, including the recognition of gains and losses, have been properly recognized; and
- the adequacy of the accounting and disposition controls for, as well as the quality of, the asset.

With regard to transaction volume, the examiner should evaluate whether any accounts with small balances have an unusually high level of transaction volume. Therefore, it is important that the examiner verify that—

- the account has a valid business purpose,
- the account is reconciled on a regular basis, and
- the accounting controls are adequate.

An examiner should authenticate the existence of the selected assets by ensuring that their supporting documentation is adequate. Also, the examiner should verify that ownership of the asset rests with the bank. (In the case of organizational costs borne by the bank for the formation of a holding company, those costs, and the related ownership rights in the capitalized asset, should more properly be borne by the ownership interests and should not be recorded as assets of the bank.)

Proper valuation and reporting of other asset accounts is another potential area of concern for the examiner. Assets are generally acquired through purchase, trade, repossession, prepayment of expenses, or accrual of income. Generally, assets purchased, traded, or repossessed are transferred at their fair market value. Prepaid expenses and income accrued are booked at cost. An examiner should be particularly alert in identifying those assets that lose value over time to ensure that they are appropriately depreciated or amortized. All intangible assets should be regularly amortized, and management should have a system in place to confirm the valuation of the remaining book balance of the intangible assets.

The examiner needs to ensure that the controls concerning other assets protect the bank's ownership rights, the accounts are properly valued and accurately reported, and control activities are monitored regularly by management. A bank with good control and review procedures will periodically charge off all uncollectible or unreconcilable items. However, the examiner must frequently go beyond the general ledger control accounts and scan the underlying subsidiary ledgers to ensure that posting errors and the common practice of netting certain accounts against each other do not cause significant balances to go unnoticed because of lack of proper detail.

Deferred Tax Assets

For verifying compliance with the limits found in the risk-based capital guidelines, examiners need to review the net deferred tax assets (deferred tax assets less deferred tax liabilities) that a bank reports in its regulatory reports and the amount of limited deferred tax assets that are not deducted from a bank's tier 1 capital. The net deferred taxes result from the application of an asset and liability approach for financial-accounting and reporting for income taxes. Net deferred taxes (net deferred tax assets) generally arise from the tax effects of reporting income or expense charges in one period for financial-statement purposes and in another period for tax purposes. This effect, known as a temporary difference, is at times sizable. Tax laws often differ from the recognition and measurement requirements of financial accounting standards. Differences can arise between (1) the amount of taxable income and pretax financial income for a year and (2) the tax bases of assets or liabilities and their reported amounts in financial statements. Charges that result in a significant deferred tax asset are often caused by loan-loss provisions exceeding bad debt deductions for tax purposes in a given period. While banks are permitted to carry deferred income tax assets on their reports of condition, they are limited by generally accepted accounting principles (GAAP) to the extent these items can be carried.

The Financial Accounting Standards Board's (FASB) Statement No. 109 (FAS 109), "Accounting for Income Taxes," establishes procedures to (1) measure deferred tax assets and liabilities using a tax-rate convention and (2) assess whether a valuation allowance should be established for deferred tax assets. Enacted tax laws and rates are considered in determining the applicable tax rate and in assessing the need for a valuation allowance. FAS 109 was to be adopted by banks as of January 1, 1993, or the beginning of their first fiscal year thereafter, if later.

FAS 109 requires a deferred tax asset to be recognized for all temporary differences that will result in deductible amounts in future years and for tax credit carryforwards. For example, a temporary difference may be created between the reported amount and the tax basis of a liability for estimated expenses if, for tax purposes, those estimated expenses are not deductible until a future year. Settlement of that liability will result in tax deductions in future years, and a deferred tax asset is recognized in the current year for the reduction in taxes payable in future years. A valuation allowance is recognized (deducted from the amount of the deferred tax asset) if, based on the weight of available evidence, it is *likely* that some or all of the deferred tax asset will not be realized.

Deferred Tax Liabilities

A deferred tax liability is recognized for temporary differences that will result in taxable amounts in future years. Deferred tax liabilities that may be related to a particular tax jurisdiction (for example, federal, state, or local) may be offset against each other for reporting purposes. A resulting debit balance is included in ''other assets'' on the bank Call Report and reported in Schedule RC-F; a resulting credit balance is included in ''other liabilities'' on the bank Call Report and reported in Schedule RC-G. A bank may report a net deferred tax debit (or asset) for one tax jurisdiction (for example, federal taxes) and also report a net deferred tax credit (or liability) for another tax jurisdiction (for example, state taxes).

Limitation on Deferred Tax Assets for Tier 1 Risk-Based Capital and Leverage Capital

The risk-based capital and leverage capital guidelines include a limit on the amount of certain deferred tax assets that may be included in (that is, not deducted from) tier 1 capital for determining the amount of the bank's required risk-based and leverage capital levels. Certain deferred tax assets can only be realized if a bank earns taxable income in the future. Deferred tax assets are limited, for regulatory capital purposes, to (1) the amount that the bank expects to realize within one year of the quarter-end report date (based on its projections of future taxable income for that year) or (2) 10 percent of tier 1 capital, whichever is less. The reported amount of deferred tax assets, net of any valuation allowance for deferred tax assets, in excess of the lesser of these two amounts is to be deducted from a bank's core capital elements in determining tier 1 capital. See section 3020.1 for more detailed information on how to determine the capital composition and limitation on deferred tax assets.

Bank-Owned Life Insurance to Be Included in Other Assets

FASB's Technical Bulletin No. 85-4 (FTB 85-4), "Accounting for the Purchases of Life Insurance," addresses the accounting for BOLI. "Other assets" are to include the amount of the assets that represent the cash surrender value of the insurance policy that is reported to the institution by the insurance carrier (less any applicable surrender charges not reflected by the insurance carrier in the reported cash surrender value that could be realized under the insurance contract) as of the balance-sheet date. Because there is no right of offset, an investment in BOLI is reported as an asset separately from any deferred compensation liability. BOLI is reported on the balance sheet of the bank Call Report as "other assets" and on its schedule RC-F as "all other assets—cash surrender value of life insurance." (See SR-04-4 and SR-04-19.) (The net earnings (losses) on, or the net increases (decreases) in, the net cash surrender value of BOLI should be reported according to the bank Call Report instructions for the glossary and the income statement, Schedules RI and RI-E.)

OTHER LIABILITIES

The term *other liabilities* represents the bank's authorized obligations. Other liabilities, as used in this section, include all balance-sheet liability accounts not covered specifically in other areas of the examination. The accounts often may be quite insignificant when compared with the overall size of the bank. In some banks, individual accounts are established for control purposes and appear on the balance sheet as "other liabilities." For reporting, however, these accounts must be assigned to specific liability categories or netted from related asset categories, as appropriate.

Schedule RC-G of the Consolidated Report of Condition lists the specific accounts classified as "other liabilities." The schedule includes interest accrued and unpaid on deposits and other expenses that are accrued and unpaid (including accrued income taxes payable), net deferred tax liabilities, the allowance for credit losses on off-balance-sheet credit exposures, and all other liabilities. "All other liabilities" includes liability accounts such as accounts payable, deferred compensation liabilities, dividends that are declared but not yet payable, and derivatives with a negative fair value held for purposes other than trading.

As stated above, the "all other liabilities" term includes deferred compensation liabilities. This account is used to record the bank's obligation under its deferred compensation agreements. Section 3015.1 discusses deferred compensation agreements in detail, both as to the nature and operation of the different types of agreements and the accounting standards and guidance that are applicable to those agreements—in particular, a revenue-neutral plan or an indexed retirement plan. (See also SR-04-4, SR-04-19, and the glossary entry for "deferred compensation agreements" in the bank Call Report instructions.)

Types of Other Liability Accounts

A general category of other liabilities common to banks is expenses accrued and unpaid. These accounts represent periodic charges to income based on anticipated or contractual payments of funds to be made at a later date. They include such items as interest on deposits, dividends, taxes, and expenses incurred in the normal course of business. There should be a correlation between the amount being accrued daily or monthly and the amount due on the stated or anticipated payment date.

Other liability accounts should be reviewed to determine that accounts, such as deferred taxes, are being properly recognized when there are temporary differences in the recognition of income and expenses between the books and the income tax returns. This review should also determine that matters such as pending tax litigation, equipment contracts, and accounts payable have been properly recorded and are being discharged in accordance with their terms and requirements.

Various miscellaneous liabilities may be found in accounts, such as undisbursed loan funds, deferred credits, interoffice, suspense, and other titles denoting pending status. An unlimited number of possible items could be included. The review of these accounts should determine that they are used properly and that all such items are clearing in the normal course of business. Because of the variety of such accounts, the examiner must develop specific examination procedures to fit the particular account and situation.

Examination Review of Other Liabilities

Examiners assigned to "other liabilities" are responsible for obtaining the bank's breakdown of these accounts and, when the accounts are to be examined under other sections, must ensure that examiners in charge of those sections receive the necessary information. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The primary emphasis of examining other liabilities is to obtain reasonable assurance that (1) the liabilities represent the bank's authorized obligations and (2) all contingencies and estimated current-period expenses that will be paid in future periods that should be accrued during the period have been accrued, classified, and described in accordance with GAAP, and the related disclosures are adequate. Another emphasis in examining this area should be the adequacy of the controls and procedures the bank employs to promptly record the amount of liability. Without proper management attention, these accounts may be advertently or inadvertently misstated. Unless properly supervised, these accounts may be used to conceal shortages that should be detected immediately. For instance, other liabilities may include fraudulent entries for suspense or interbranch accounts that could be rolled over every other day to avoid stale dates, causing shortages of any amount to be effectively concealed for indefinite periods of time.

Similar to "other assets," other liability accounts with small balances may be significant. Scanning account balances may disclose a recorded liability, but it does not aid in determining the accuracy of liability figures. Therefore, it is important to review the documented information obtained from examiners working with and reviewing the minutes of the board and its committees. Responses from legal counsel handling litigation could also be important because this information might reveal a major understatement of liabilities. Determining accurate balances in other liability accounts requires an in-depth review of source documents or the other accounts in which the liability arose.

Other Assets and Other Liabilities

Examination Procedures

Effective date May 2022

Section 2300.3

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Other Assets and Liabilities

Cash accounts include U.S. and foreign coin and currency on hand and in transit, clearings, and cash items.

CASH

Every bank maintains a certain amount of U.S. currency and some may have foreign currency on hand. To avoid having excess nonearning assets and to minimize exposure to misappropriation and robbery, each bank should establish a policy to maintain cash balances at the minimum levels necessary to serve its customers. The amount will vary from bank to bank depending on anticipated needs of customers and the availability of replenishment monies, with a reasonable allowance made for unusual demands.

Foreign currency may not be included in cash positions for management purposes when the amounts are not significant. However, the coin and currency of other countries are foreign-currency assets, as are loans or nostro accounts, and should be included in the foreign-currency positions.

CLEARINGS

Clearings are checks, drafts, notes, and other items that a bank has cashed or received for deposit that are drawn on other local banks and cleared directly with them. These items can usually be exchanged more efficiently among local banks than through correspondent banks or the Federal Reserve System. Many communities with two or more banks have formally organized clearinghouse associations, which have adopted rules governing members in the exchange of checks. Clearinghouse associations often extend their check-exchange arrangements to other nearby cities and towns. In most banks, clearings will be found in the department responsible for processing checks.

Proof and transit were once two separate functions in a bank: the proving of work (proof) and the sending of out-of-town cash items (transit) for collection. Most banks have now combined these two functions. Proof and transit may be performed by any combination of tellers or proof clerks, a separate proof and transit department, a check-processing department, an outclearing department, or some other department that is characteristic of the area of the country where the bank operates. The functions may be centralized or decentralized, manual or automated, depending on the size of the bank and the volume of transactions. The volume of clearings may be so great that the bank's proof operations are conducted after time deadlines for transaction posting or courier delivery. In these cases, daily clearings customarily are determined as of a specific cutoff time. Checks processed to that time are carried in one day's totals, and checks processed after that time are carried in the following day's totals. However, no matter who performs the function or how large the bank, the objectives of a proof and transit system are the same:

- to forward items for collection so that funds are available as soon as possible
- to distribute all incoming checks and deposits to their destinations
- to establish whether deposit totals balance with the totals shown on deposit tickets
- to prove the totals of general ledger entries and other transactions
- to collect data for computing the individual customer's service charges and determining the availability of the customer's funds
- to accomplish the assigned functions at the lowest possible cost

CASH ITEMS

Cash items are checks or other items in the process of collection that are payable in cash upon presentation. A separate control of all cash items is usually maintained on the bank's general ledger and, if applicable, on the international division general ledger. The ledger is supported by a subsidiary record of individual amounts and other pertinent data. Cash items and the related records are usually in the custody of one employee at each banking office.

In their normal daily operations, banks have an internal charge, on the general ledger, to total demand deposits not charged to individual accounts because of insufficient funds, computer misreads, or other problems. Commonly known as return items or rejected or unposted debits, these items may consist of checks received in the ordinary course of business, loan-payment debits, and other debit memos. In some banks, return items are separated by the bookkeepers and an entry is made reclassifying them to a separate asset account entitled ''bookkeepers' return items.'' Other banks do not use a separate asset account; instead, the bookkeepers include the items in a subsidiary control account in the individual demand deposit ledgers. In that case, the account would have a debit balance and would be credited when the bank processes items for posting or returns the checks to their source.

Since bookkeepers' return items are usually processed and posted to an individual account or returned to their source on the next business day, the balance of the bookkeepers' return items account should represent the total of only one day's returned items.

When data processing systems are used, the common practice is to post all properly encoded debit items, regardless of whether an overdraft is created. The resulting preliminary overdraft list, together with the items charged, is subsequently reviewed by bank employees, and unapproved items are reversed and separated as bookkeepers' return items. The total of the resulting final overdraft list becomes the final overdraft figure shown on the general ledger. The examination of overdrafts is discussed in ''Deposit Accounts,'' section 3000.1. The examination of international overdrafts is discussed in ''Due from Banks,'' ''Borrowed Funds,'' and ''International—Foreign Exchange,'' sections 2010.1, 3010.1, and 7100.1, respectively.

Several types of cash items should be considered ''cash items not in the process of collection'' and shown in an appropriate ''other assets'' account. Some examples are (1) items that are payable upon presentation but which the bank has elected to accumulate and periodically forward to the payor, such as Series EE bonds or food stamps; (2) items that are not immediately payable in cash upon presentation; and (3) items that were not paid when presented and require further collection effort.

In addition to those items carried in the separate ''cash items'' account on the general ledger, most banks will have several sources of internal float in which irregular cash items can be concealed. Such items include any memoranda slips; checks drawn on the bank; checks returned by other banks; checks of directors, officers, employees, and their interests; checks of affiliates; debits purporting to represent currency or coin shipments; notes, usually past due; and all aged and unusual items of any nature that might involve fictitious entries, manipulations, or uncollectible accounts.

CURRENCY TRANSACTIONS

The reporting of currency and foreign transactions as covered in 31 CFR 1010 requires financial institutions to maintain records that might be useful in criminal, tax, or regulatory investigations. The regulation also seeks to identify persons who attempt to avoid payment of taxes through transfers of cash to or from foreign accounts. The examination procedures for determining compliance with the regulation require the examiner to ascertain the quality of the bank's auditing procedures and operating standards relating to financial recordkeeping.[1] Examiners also determine the adequacy of written policies and bank training programs. The *Bank Secrecy Act/Anti-Money Laundering Examination Manual* is to be used in checking compliance and for reporting apparent violations in the reporting of currency and foreign transactions. Any violations noted should be listed with appropriate comments in the report of examination. Inadequate compliance could result in a cease-and-desist order to effect prompt compliance with the statute.

1. Section 208.63 of Regulation H establishes procedures to ensure that state member banks establish and maintain procedures reasonably designed to ensure and monitor compliance with the regulation.

1. To determine if the policies, practices, procedures, and internal controls regarding "cash accounts" are adequate.
2. To determine if bank officers and employees 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 cash accounts section of the internal control questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal or 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 deficiencies noted in the latest review done by internal or external auditors from the examiner assigned to that area of examination, and determine if appropriate corrections have been made.
4. Scan the general ledger cash accounts for any unusual items or abnormal fluctuations. Investigate any such items and document any apparent noncompliance with policies, practices and procedures for later review with appropriate management personnel.
5. Obtain teller settlement sheet recap or similar document as of the examination date and agree to the general ledger. Scan for reasonableness and conformity to bank policy.
6. Obtain detailed listings of cash items, including any bank items which are carried in the general ledger under "other assets," agree listings to general ledger balances and scan for propriety and conformity to bank policy.
7. Test compliance with Regulation H (12 CFR 208) by—
   a. selecting teller and banking office cash-balance sheets and determining that balances are within currency limits established;
   b. selecting bait money and agreeing serial numbers to applicable records;
   c. reviewing documentation showing training sessions held since the preceding examination;
   d. performing any visual inspections deemed appropriate;
   e. analyzing the bank's system of security and protection against external crimes (Guidance for this analysis is provided in the internal control questionnaire in this section of the manual.); and
   f. determining, through discreet corroborative inquiry of responsible bank officials and review of documentation, whether a security program that equals or exceeds the standards prescribed by Regulation H (12 CFR 208.61(c)) is in effect and that the annual compliance report and any other reports requested by the Federal Reserve System have been filed.
8. Review compliance with recordkeeping requirements and currency and foreign transaction reports. (See 31 CFR 1010.)
9. Review tellers' over and short accounts for recurring patterns and any large or unusual items and follow up as considered necessary. Investigate differences centered in any one teller or banking office. Determine whether corrective action has been taken, if required.
10. Determine, by discreet corroborative inquiry of responsible bank officials and review of documentation, whether defalcations and/or mysterious disappearances of cash since the preceding examination have been properly reported pursuant to current requirements of the Board of Governors.
11. Review foreign-currency control ledgers and dollar book value equivalents for the following:
    a. accuracy of calculations and booking procedures
    b. unusual fluctuations
    c. concentrations
    d. unusual items
12. Review international division revaluation calculations and procedures.
13. Review the following items with appropriate management personnel (or prepare a memo to other examining personnel for their use in reviewing with management):
    a. internal-control exceptions and deficiencies in, or noncompliance with, written policies, practices and procedures
    b. uncorrected audit deficiencies
    c. violations of law
    d. inaccurate booking of U.S. dollar book value equivalents for foreign currencies
    e. inaccurate revaluation calculations and procedures performed by cash-account operations staff

14. Prepare comments on deficiencies orviolations of law noted above for inclusion in the examination report.
15. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal-control policies, practices, and procedures for cash accounts. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. Items marked with an asterisk require substantiation by observation or testing.

CASH ON HAND

*1. Do all tellers, including relief tellers, have sole access to their own cash supply, and are all spare keys kept under dual control?
*2. Do tellers have their own vault cubicle or controlled cash drawer in which to store their cash supply?
3. When a teller is leaving for vacation or for any other extended period of time, is that teller's total cash supply counted?
4. Is each teller's cash verified periodically on a surprise basis by an officer or other designated official (if so, is a record of such count retained)?
*5. Are cash drawers or teller cages provided with locking devices to protect the cash during periods of the teller's absence?
6. Is a specified limit in effect for each teller's cash?
*7. Is each teller's cash checked daily to an independent control from the proof or accounting control department?
8. Are teller differences cleared daily?
9. Is an individual, cumulative over and short record maintained for all persons handling cash, and is the record reviewed by management?
10. Does the teller prepare and sign a daily proof sheet detailing currency, coin, and cash items?
*11. Are large teller differences required to be reported to a responsible official for clearance?
12. Is there a policy against allowing teller "kitties"?
*13. Are teller transactions identified through use of a teller stamp?
*14. Are teller transfers made by tickets or blotter entries which are verified and initialed by both tellers?
15. Are maximum amounts established for tellers' cashing checks or allowing withdrawal from time deposit accounts without officer approval?
16. Does the currency at each location include a supply of bait money?
17. Are tellers provided with operational guidelines on check-cashing procedures and dollar limits?
18. Is a record maintained showing amounts and denominations of reserve cash?
*19. Is reserve cash under dual custody?
*20. Are currency shipments—
    a. prepared and sent under dual control and
    b. received and counted under dual control?
*21. If the bank uses teller machines—
    a. is the master key controlled by someone independent of the teller function,
    b. is the daily proof performed by someone other than the teller, and
    c. are keys removed by the teller during any absence?
*22. Is dual control maintained over mail deposits?
23. Is the night depository box under a dual lock system?
24. Is the withdrawal of night deposits made under dual control?
25. Regarding night depository transactions—
    a. are written contracts in effect;
    b. are customers provided with lockable bags; and
    c. are the following procedures completed with two employees present:
        • opening of the bags
        • initial recording of bag numbers, envelope numbers, and depositors' names in the register
        • counting and verification of the contents
*26. Regarding vault control—
    a. is a register maintained which is signed by the individuals opening and closing the vault;
    b. are time-clock settings checked by a second officer;
    c. is the vault under dual control; and
    d. are combinations changed periodically and every time there is a change in custodianship?

27. Are tellers prohibited from processing their own checks?
*28. Are tellers required to clear all checks from their funds daily?
*29. Are tellers prevented from having access to accounting department records?
*30. Are teller duties restricted to teller operations?

CASH-DISPENSING MACHINES

*31. Is daily access to the automated teller machine (ATM) made under dual control?
*32. When maintenance is being performed on a machine, with or without cash in it, is a representative of the bank required to be in attendance?
*33. Are combinations and keys to the machines controlled (if so, indicate controls)?
34. Do the machines and the related system have built-in controls that—
    a. limit the amount of cash and number of times dispensed during a specified period (if so, indicate detail) and
    b. capture the card if the wrong PIN (personal identification number) is consecutively used?
35. Does the machine automatically shut down after it experiences recurring errors?
36. Is lighting around the machine provided?
37. Does the machine capture cards of other banks or invalid cards?
38. If the machine is operated "off line," does it have negative-file capability for present and future needs, which includes lists of lost, stolen, or other undesirable cards which should be captured?
39. Is use of an ATM by an individual customer in excess of that customer's past history indicated on MIS reports reviewed for suspicious activity by bank management (for example, three uses during past three days as compared with a history of one use per month)?
40. Have safeguards been implemented at the ATM to prevent, during use, the disclosure of a customer's PIN by others observing the PIN pad?
41. Are "fish-proof" receptacles provided for customers to dispose of printed receipts, rather than insecure trash cans, etc.?
42. Does a communication interruption between an ATM and the central processing unit trigger the alarm system?
43. Are alarm devices connected to all automated teller machines?
44. For on-line operations, are all messages to and from the central processing unit and the ATM protected from tapping, message insertion, modification of message or surveillance by message encryption (scrambling techniques)? (One recognized encryption formula is the National Bureau of Standards Algorithm.)
*45. Are PINs mailed separately from cards?
*46. Are bank personnel who have custody of cards prohibited from also having custody of PINs at any stage (issuance, verification, or reissuance)?
47. Are magnetic stripe cards encrypted (scrambled) using an adequate algorithm (formula) including a total message control?
48. Are encryption keys, i.e., scramble plugs, under dual control of personnel not associated with operations or card issuance?
*49. Are captured cards under dual control of persons not associated with bank operation card issuance or PIN issuance?
*50. Are blank plastics and magnetic stripe readers under dual control?
51. Are all cards issued with set expiration dates?
52. Are transaction journals provided that enable management to determine every transaction or attempted transaction at the ATM?

CASH ITEMS

*53. Are returned items handled by someone other than the teller who originated the transaction?
54. Does an officer or other designated individual review the disposition of all cash items over a specified dollar limit?
55. Is a daily report made of all cash items, and is it reviewed and initialed by the bank's operations officer or other designated individual?
56. Is there a policy requiring that all cash items uncollected for a period of 30 days be charged off?

57. Do the bank's present procedures forbid the holding of overdraft checks in the cash-item account?
58. Are all cash items reviewed at least monthly at an appropriate level of management?
*59. Are cash items recommended for charge-off reviewed and approved by the board of directors, a designated committee thereof, or an officer with no operational responsibilities?

PROOF AND TRANSIT

60. Are individuals working in the proof and transit department precluded from working in other departments of the bank?
61. Is the handling of cash letters such that—
    a. they are prepared and sent on a daily basis;
    b. they are photographed before they leave the bank;
    c. copy of proof or hand-run tape is properly identified and retained;
    d. records of cash letters sent to correspondent banks are maintained with identification of the subject bank, date, and amount; and
    e. remittances for cash letters are received by employees independent of those who send out the cash letters?
62. Are all entries to the general ledger either originated or approved by the proof department?
63. Are all entries prepared by the general ledger and/or customer accounts department reviewed by responsible supervisory personnel other than the person preparing the entry?
64. Are errors detected by the proof operator in proving deposits corrected by another employee or designated officer?
65. Are all postings to the general ledger and subsidiary ledgers supported by source documents?
66. Are returned items—
    *a. handled by an independent section of the department or delivered unopened to personnel not responsible for preparing cash letters or handling cash,
    b. reviewed periodically by responsible supervisory personnel to determine that items are being handled correctly by this section and are clearing on a timely basis,
    *c. scrutinized for employee items, and
    d. reviewed for large or repeat items?
67. Are holdover items—
    a. appropriately identified in the general ledger,
    *b. handled by an independent section of the department, and
    c. reviewed periodically by responsible supervisory personnel to determine that items are clearing on a timely basis?
68. Does the proof and transit department maintain a procedures manual describing the key operating procedures and functions within the department?
*69. Are items reported missing from cash letter promptly traced and a copy sent for credit?
*70. Is there a formal system to ensure that work distributed to proof machine operators is formally rotated?
71. Are proof machine operators prohibited from—
    a. filing checks or deposit slips or
    b. preparing deposit account statements?
72. Are proof machine operators instructed to report unusually large deposits or withdrawals to a responsible officer (if so, over what dollar amount $___________)?

REGULATION H (12 CFR 208)—COMPLIANCE QUESTIONNAIRE

73. Has a security officer been designated by the board of directors in accordance with Regulation H (12 CFR 208.61(b))?
74. Has a security program been developed and implemented in accordance with Regulation H (12 CFR 208.61(c))?
75. Does the bank have security devices that give a general level of protection and that are at least equivalent to the minimum requirements of Regulation H?
76. Has the installation, maintenance, and operation of security devices considered the operating environment of each office and the requirements of Regulation H (12 CFR 206.61(c))?
77. Does the security officer report at least annually to the bank's board of directors on the administration and effectiveness of

the security program in accordance with Regulation H (12 CFR 206.61(d))?

31 CFR 1010—COMPLIANCE QUESTIONNAIRE

78. Is the bank in compliance with the financial recordkeeping and reporting regulations?

INTERNATIONAL DIVISION

*79. Are foreign-currency control ledgers and dollar-book-value equivalents posted accurately?
*80. Is each foreign currency revalued at least monthly, and are profit and loss entries passed on to the appropriate income accounts?
*81. Are revaluation calculations, including the rates used, periodically reviewed for accuracy by someone other than the foreign-currency tellers?
*82. Does the internal auditor periodically review for accuracy revaluation calculations, including the verification of rates used and the resulting general ledger entries?

CONCLUSION

83. Is the foregoing information considered 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.
84. Based on a composite evaluation as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate). A separate evaluation should be made for each area, i.e., cash on hand, cash items, etc.

Banks maintain deposits in other banks to facilitate the transfer of funds. Those bank assets, known as "due from bank deposits" or "correspondent bank balances"[1] are a part of the primary, uninvested funds of every bank. A transfer of funds between banks may result from the collection of cash items and cash letters, the transfer and settlement of securities transactions, the transfer of participating loan funds, the purchase or sale of federal funds, and many other causes.

In addition to deposits kept at the Federal Reserve Bank and with correspondent banks, a bank may maintain interest-bearing time deposits with international banks. Those deposits are a form of investment, and relevant examination considerations are included in "Investment Securities and End-User Activities," section 2020.1, and "International—Due from Banks—Time," section 7070.1.

Banks also use other banks to provide certain services that can be performed more economically or efficiently by another facility because of its size or geographic location. These services include processing of cash letters, packaging loan agreements, performing EDP services, collecting out-of-area items, providing safekeeping for bank and customer securities, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one way, the receiving bank usually maintains a minimum balance at the providing bank to compensate in full or in part for the services received.

DEPOSITS WITH OTHER DEPOSITORY INSTITUTIONS

Section 206.3 of Regulation F (12 CFR 206) requires FDIC-insured depository institutions to adopt written policies and procedures to address the risk arising from exposure to a correspondent, and to prevent excessive exposure to any individual correspondent. These policies and procedures should take into account the financial condition of a correspondent and the size, form, and maturity of the exposure. Section 206.4(a) of Regulation F stipulates that any FDIC-insured depository institution must limit its interday credit exposure to an individual correspondent that is not "adequately capitalized"[2] to 25 percent of the institution's total capital.[3] For a more detailed discussion of Regulation F, refer to sections 2015.1–.4 and SR-93-36 ("Examiner Guidelines for Regulation F—Interbank Liabilities").

BALANCES WITH FEDERAL RESERVE BANKS

All state member banks are required by Regulation D (12 CFR 204) to keep reserves equal to specified percentages of the deposits on their books. These reserves are maintained in the form of vault cash or deposits with the Federal Reserve Bank. The Federal Reserve Bank monitors the deposits of each bank to determine that reserves are kept at required levels. The reserves provide the Federal Reserve System with a means of controlling the nation's money supply. Changes in the level of required reserves affect the availability and cost of credit in the economy. The examiner must determine that the information supplied to the Federal Reserve Bank for computing reserves is accurate.

The Monetary Control Act of 1980 enables a nonmember financial institution to borrow from the Reserve Bank's discount window on the same terms and conditions as member banks. For member banks, loan transactions are usually effected through their reserve account. For nonmember banks, the Reserve Bank typically requires the institution to open a special account called a clearing account. The loan transactions are then processed through the clearing account. However, in some instances, the Reserve Bank may allow a nonmember institution to process discount loan transactions through the account of a member bank. In most of these isolated

1. Balances due from such institutions include all interest-bearing and non-interest-bearing balances, whether in the form of demand, savings, or time balances, including certificates of deposit, but excluding certificates of deposit held in trading accounts.

2. See section 206.5(a) of Regulation F for the capital ratios necessary for a correspondent bank to be considered adequately capitalized.

3. The Board may waive this requirement if the primary federal supervisor of the insured institution advises the Board that the institution is not reasonably able to obtain necessary services, including payment-related services and placement of funds, without incurring exposure to a correspondent in excess of the otherwise applicable limit.

cases, a transaction of a nonmember institution is being processed through the account of the bank with which the nonmember institution has a correspondent relationship.

Under the reserve account charge agreements used by most Federal Reserve Banks, the member bank's reserve account may be charged if the nonmember bank defaults on the loan processed through the member bank's account. Since member banks may not act as the guarantor of the debts of another, member banks may only legally enter into revocable reserve account charge agreements. Revocable agreements allow the member bank, at its option, to revoke the charge and thus avoid liability for the debt of the nonmember correspondent. In contrast, irrevocable charge agreements constitute a binding guarantee of the nonmember correspondent's debt and generally cannot be entered into by a member bank. Banks that enter into revocable charge agreements should establish written procedures to ensure their ability to make prudent, timely decisions.

DEPOSIT BROKERS

On the asset side of the balance sheet, examiners should review the activities of banks that place deposits through money brokers. These banks should have sufficient documentation to, among other things, verify the amounts and terms of individual deposits and the names of depository institutions in which the deposits are placed. Banks should also be able to demonstrate that they have exercised appropriate credit judgment with respect to each depository institution in which they have placed funds. Deficiencies in this area could constitute an unsafe or unsound banking practice. A more detailed discussion of brokered deposits is included in "Deposit Accounts," sections 3000.1–3000.3 of this manual.

DUE FROM FOREIGN BANKS

Due from foreign banks demand or nostro accounts are handled in the same manner as due from domestic bank accounts, except that the balances due are generally denominated in foreign currency.

A bank must be prepared to make and receive payments in foreign currencies to meet the needs of its international customers. This can be accomplished by maintaining accounts (nostro balances) with banks in foreign countries in whose currencies receipts and payments are made.

Nostro balances may be compared with an inventory of goods and must be supervised in the same manner. For example, payment to import goods manufactured in Switzerland to the United States can be made through a U.S. bank's Swiss franc account with another bank in Switzerland. Upon payment in Switzerland, the U.S. bank will credit its nostro account with the Swiss bank and charge its U.S. customer's dollar account for the appropriate amount in dollars. Conversely, exporting U.S. goods to Switzerland results in a debit to the U.S. bank's Swiss correspondent account. The first transaction results in an outflow of the U.S. bank's "inventory" of Swiss francs, while the second transaction results in an inflow of Swiss francs. The U.S. bank must maintain adequate balances in its nostro accounts to meet unexpected needs and to avoid overdrawing those accounts for which interest must be paid. However, the bank should not maintain excessive idle nostro balances that do not earn interest, causing a loss of income.

The U.S. bank also runs risks by being either long or short in a particular foreign currency or by maintaining undue gaps. Losses could result if that currency appreciates or depreciates significantly or if the bank must purchase or borrow the currency at a higher rate.

Excessive nostro overages and shortages can be avoided by entering into spot and forward exchange contracts to buy or sell such nostro inventories. Those contracts are discussed in "International—Foreign Exchange," section 7100.1. However, all foreign-currency transactions, except over-the-counter cash trades, are settled through nostro accounts. Therefore, the volume of activity in those accounts may be substantial, and the accounts must be properly controlled.

In addition, an account service known as a payable-through account is being marketed by U.S. banks, Edge corporations, and the U.S. branches and agencies of foreign banks to foreign banks that otherwise would not have the ability to offer their customers access to the U.S. banking system. This account service, referred to by other names such as pass-through accounts and pass-by accounts, involves a U.S. banking entity's opening of a deposit account for the foreign bank. Policies and procedures should be developed to guard against the possible improper or illegal use of payable-through account facilities by foreign banks and their customers. Examination procedures relating to this area are part of the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual*.

1. To determine if the policies, practices, procedures, and internal controls regarding due from banks are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.
4. To evaluate the credit quality of banks with whom demand accounts are maintained.
5. To determine the scope and adequacy of the audit coverage.
6. To determine compliance with laws, rulings, and regulations.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

1. If selected for implementation, complete or update the Due From Banks Internal Control Questionnaire.
2. Determine the scope of the examination, based on the evaluation of internal controls and the work performed by internal/external auditors.
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 deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if corrections have been accomplished.
4. Scan the most recent bank-prepared reconcilements for any unusual items and determine that closing balances listed on reconcilements agree with the general ledger and with the balance shown on the cut-off statement if one has been obtained.
5. If the bank's policy for charge-off of old open items provides for exceptions in extenuating circumstances, review excepted items and determine if charge-off is appropriate.
6. If the bank has no policy for charge-off of old open items, review any items which are large or unusual or which have been outstanding for over two months, along with related correspondence, and determine if charge-off is appropriate.
7. Test the bank's calculation of its Federal Reserve requirement and determine that reports are accurate and complete by:
   a. Performing a limited review of a sample of line items if the bank has effective operating procedures and has an audit program covering the required reports.
   b. Performing a detailed review of all line items if the bank has not established operating procedures or does not have an audit program covering the required reports.
8. Confer with the examiner assigned to check for compliance with the laws and regulations relating to insider loans at correspondent banks and loans to insiders of correspondent banks (Regulation O and 12 USC 1972(2)) and either provide a list, or verify a bank supplied list, of correspondent banks. (This effort should be coordinated with the examiner assigned to "Deposit Accounts" to avoid duplication of work.)
9. Review the maximum deposit balance established for each due from bank account and determine if the maximum balance:
   a. Is established after consideration of compensating balance requirements resulting from commitments or credit lines made available to the bank or its holding company. Coordinate this effort with examiner assigned "Bank-Related Organizations."
   b. Appears to be related to loans of executive officers or directors or to loans which have been used to acquire stock control of the bank under examination.
      - If such due from accounts are detected, provide full details of the account to the examiner assigned to check for compliance with the law relating to loans to insiders of correspondent banks (12 USC 1972(2)).
10. Determine the existence of any concentrations of assets with other banks. Include correspondent accounts, time deposits and any federal funds sold in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward the information to examiners assigned "Concentrations of Credit" for possible inclusion in the report of examination.

Note: Procedures 11 through 21 apply to due from foreign banks—demand (nostro accounts).

11. Obtain or prepare a trial balance (including local currency book values) of due from foreign banks—demand by bank customer and:
    a. Agree or reconcile balances to department controls and the general ledger.
    b. Review reconciling items for reasonableness.
12. Using the appropriate sampling technique, select demand account banks for examination.
13. Prepare credit line sheets to include:

a. Customer's aggregate due from banks—demand liability in foreign currency amount and local currency equivalent.
b. Amount of customer's line designated by the bank.
c. Frequency of recent overdrawn nostro accounts.

(Overdrawn nostro accounts as they relate to foreign exchange activities are discussed in the International—Foreign Exchange section. Also, the examiner assigned "Borrowed Funds" must obtain (or prepare) a listing of overdrawn nostro accounts for inclusion in the borrowing section of the report of examination.)

d. Past compliance with customer's line limitation as determined from review of liability ledger records.

14. Obtain from the examiner assigned "International—Loan Portfolio Management," schedules on the following, if they are applicable to the due from foreign banks—demand:
   a. Delinquencies.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Criticized shared national credits.
   d. Interagency Country Exposure Review Committee credits.
   e. Loans criticized during the previous examination.
   f. Information on directors, officers and their interests, as contained in statements required under Regulation O (12 CFR 215).
   g. Specific guidelines in the bank policy relating to due from banks—demand.
   h. Current listing of due from foreign banks—demand approved customer lines.
   i. Any useful information resulting from the review of the minutes of the loan and discount committee or any similar committee.
   j. Reports furnished to the board of directors.
15. Review the information received and perform the following for:
   a. Miscellaneous loan debit and credit suspense accounts:
      • Discuss with management any large or old items.
      • Perform additional procedures as deemed appropriate.
   b. Interagency Country Exposure Review Committee Credits:
      • Compare the schedule to the trial balance to determine which due from foreign banks—demand deposits are portions of Interagency Country Exposure Review Committee credits.
      • For each due from foreign bank—demand deposit so identified, transcribe appropriate information to line sheets and forward the information to the examiner assigned "International—Loan Portfolio Management."
   c. Loans criticized during the previous examination (due from foreign banks—demand portion):
      • Determine the disposition of the due from foreign banks—demand so criticized by transcribing:
         — Current balance and payment status, or
         — Date the deposit was paid and the source of repayment.
16. Transcribe or compare information from the above schedules to credit line sheets, where appropriate, and indicate any cancelled bank lines.
17. Prepare credit line cards for any due from foreign banks—demand not in the sample which, based on information derived from the above schedules, requires in-depth review.
18. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts and loan areas and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.
19. Obtain credit files for all due from foreign banks—demand for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze the loans, perform the procedures set forth in step 14 of the International—Due From Banks–Time section.
20. By reviewing appropriate bank records, determine that:
   a. Profit or losses resulting from revaluation adjustment on net open positions spot are passed properly to the respective due from foreign bank—demand (nostro) account (usually monthly).
   b. At the delivery of the "swap" forward contract, proper entries are made to the

respective due from foreign bank—demand (nostro) and swap adjustment accounts.

21. Determine compliance with laws, regulations and rulings pertaining to due from foreign banks—demand activities by performing the following for:
    a. Reporting of Foreign Exchange Activities:
        - Determine that Foreign Currency Forms FC-1, FC-2, FC-1a and FC-2a, as required, are submitted to the Department of the Treasury under the provisions of 31 CFR 128.
        - Check that copies of those forms are forwarded by each state member bank to the Federal Reserve at each filing time specified in 31 CFR 128.

    Note: Due from foreign banks—demand (nostro) deposits will be reviewed, discussed with appropriate bank officers, and prepared in suitable report form by the examiner assigned ''International—Due From Banks–Time'', if the bank maintains international due from banks—time and/or call money deposits.

22. Forward list of due from banks accounts to the examiner assigned to ''Investment Securities'' and to ''Loan Portfolio Management.''
23. Consult with the examiner assigned ''Asset/Liability Management'' and provide the following, if requested:
    a. A listing, by maturity and amount, of due from banks—time deposits.
    b. The amounts of due from banks—demand deposits that exceed the required reserve balance at the Federal Reserve Bank and that exceed the working balances at correspondent banks.
24. Discuss with appropriate officer(s) and prepare in suitable report form of:
    a. Cancelled due from foreign banks—demand deposit lines that are unpaid.
    b. Violations of laws, regulations and rulings.
    c. Internal control exceptions and deficiencies, or noncompliance with written policies, practices and procedures.
    d. Any items to be considered for charge-off.
    e. Uncorrected audit deficiencies.
    f. Due from foreign banks—demand deposits not supported by current and complete financial information.
    g. Due from foreign banks—demand deposits on which documentation is deficient.
    h. Concentrations.
    i. Criticized loans (portions applicable to due from foreign banks—demand deposits).
    j. Due from foreign banks—demand deposits which for any other reason are questionable as to quality and ultimate collection.
    k. Other matters regarding condition of the department.
25. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for due from bank accounts. 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.

POLICIES FOR DUE FROM BANK DOMESTIC AND FOREIGN—DEMAND ACCOUNTS

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for due from bank accounts that:
   a. Provide for periodic review and approval of balances maintained in each such account?
   b. Indicate person(s) responsible for monitoring balances and the application of approved procedures?
   c. Establish levels of check-signing authority?
   d. Indicate officers responsible for approval of transfers between correspondent banks and procedures for documenting such approval?
   e. Indicate the supervisor responsible for regular review of reconciliations and reconciling items?
   f. Indicate that all entries to the accounts are to be approved by an officer or appropriate supervisor and that such approval will be documented?
   g. Establish time guidelines for charge-off of old open items?
2. Are the policies for due from bank accounts reviewed at least annually by the board or the board's designee to determine their adequacy in light of changing conditions?

BANK RECONCILEMENTS

3. Are bank reconcilements prepared promptly upon receipt of the statements?

*4. Are bank statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare bank reconcilements (if so, skip question 5)?

*5. If the answer to question 4 is no, are bank statements and paid drafts or payments handled before reconcilement only by persons who do not also:
   a. Issue drafts or official checks and prepare, add or post the general or subsidiary ledgers?
   b. Handle cash and prepare, add or post the general ledger or subsidiary ledgers?

*6. Are bank reconcilements prepared by persons who do not also:
   a. Issue drafts or official checks?
   b. Handle cash?
   c. Prepare general ledger entries?

7. Concerning bank reconcilements:
   a. Are amounts of paid drafts or repayments compared or tested to entries on the ledgers?
   b. Are entries or paid drafts examined or reviewed for any unusual features?
   c. Whenever a delay occurs in the clearance of deposits in transit, outstanding drafts and other reconciling items, are such delays investigated?
   d. Is a record maintained after an item has cleared regarding the follow-up and reason for any delay?
   e. Are follow-up and necessary adjusting entries directed to the department originating or responsible for the entry for correction with subsequent review of the resulting entries by the person responsible for reconcilement?
   f. Is a permanent record of the account reconcilement maintained?
   g. Are records of the account reconcilements safeguarded against alteration?
   h. Are all reconciling items clearly described and dated?
   i. Are details of account reconcilement reviewed and approved by an officer or supervisory employee?
   j. Does the person performing reconcilements sign and date them?

k. Are reconcilement duties for foreign demand accounts rotated on a formal basis?

DRAFTS

8. Are procedures in effect for the handling of drafts so that:
   *a. All unissued drafts are maintained under dual control?
   b. All drafts are prenumbered?
   c. A printer's certificate is received with each supply of new prenumbered drafts?
   d. A separate series of drafts is used for each bank?
   e. Drafts are never issued payable to cash?
   f. Voided drafts are adequately cancelled to prevent possible reuse?
   *g. A record of issued and voided drafts is maintained?
   *h. Drafts outstanding for an unreasonable period of time (perhaps six months or more) are placed under special controls?
   i. All drafts are signed by an authorized employee?
   *j. The employees authorized to sign drafts are prohibited from doing so before a draft is completely filled out?
   *k. If a check-signing machine is used, controls are maintained to prevent its unauthorized use?

FOREIGN CASH LETTERS

9. Is the handling of foreign cash letters such that:
   a. They are prepared and sent on a daily basis?
   b. They are copied or photographed prior to leaving the bank?
   c. A copy of proof or hand run tape is properly identified and retained?
   d. Records of foreign cash letters sent to correspondent banks are maintained, identifying the subject bank, date and amount?

FOREIGN RETURN ITEMS

10. Are there procedures for the handling of return items so that:
    *a. They are delivered unopened and reviewed by someone who is not responsible for preparation of cash letters?
    b. All large unusual items or items on which an employee is listed as maker, payee or endorser are reported to an officer?
    c. Items reported missing from cash letters are promptly traced and a copy sent for credit?

FOREIGN EXCHANGE ACTIVITIES

*11. Are persons handling and reconciling due from foreign bank—demand accounts excluded from performing foreign exchange and position clerk functions?

*12. Is there a daily report of settlements made and other receipts and payments of foreign currency affecting the due from foreign bank—demand accounts?

*13. Is each due from foreign bank—-demand foreign currency ledger revalued monthly and are appropriate profit or loss entries passed to applicable subsidiary ledgers and the general ledger?

*14. Does an officer not preparing the calculations review revaluations of due from foreign bank—demand ledgers, including the verification of rates used and the resulting general ledger entries?

OTHER—FOREIGN

*15. Are separate dual currency general ledger or individual subsidiary accounts maintained for each due from foreign bank—demand account, indicating the foreign currency balance and a U.S. dollar (or local currency) equivalent balance?

16. Do the above ledger or individual subsidiary accounts clearly reflect entry and value dates?

17. Are the above ledger or individual subsidiary accounts balanced to the general ledger on a daily basis?

18. Does international division management receive a daily trial balance of due from

foreign bank—demand customer balances by foreign currency and U.S. dollar (or local currency) equivalents?

OTHER

19. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?
20. Are overdrafts of domestic and foreign due from bank accounts properly recorded on the bank's records and promptly reported to the responsible officer?
21. Are procedures for handling the Federal Reserve account established so that:
    a. The account is reconciled on a daily basis?
    b. Responsibility is assigned for assuring that the required reserve is maintained?
    c. Figures supplied to the Federal Reserve for use in computing the reserve requirement are reviewed to ensure they do not include asset items ineligible for meeting the reserve requirement, and that all liability items are properly classified as required by Regulation D and its interpretations?
22. Does the foregoing information constitute 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.
23. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

INTRODUCTION

Deposits are funds that customers place with a bank, which the bank is obligated to repay on demand, after a specific period of time, or after expiration of some required notice period. Banks use deposits in a variety of ways, primarily to fund loans and investments. At most banks, deposits are the primary source of funding. Other sources of bank funding include loans from the Federal Home Loan Bank (FHLB) System, borrowing in the federal funds market, and discount window borrowing as well as subordinated debt.

The movement of deposits can have a significant effect on a bank's liquidity risk. For example, competition for funds with other banks could lead to deposit outflows. Furthermore, the need for most individuals and corporations to minimize idle funds could result in deposits moving to other higher-yielding markets. However, during times of bank stress, stable deposits can provide a bank with a reliable funding source and can mitigate liquidity risk.

Interest paid on deposits generally represents a significant expense to a bank, and therefore affects bank earnings. By offering interest rates significantly higher than local and national market levels, a bank can increase its interest-bearing deposits more quickly. However, this strategy can substantially increase a bank's funding costs. In addition, high-interest-rate deposits may attract customers that are highly rate sensitive that would require a bank to match market rates to retain the deposits. There are other operating costs associated with attracting and administering deposit accounts, such as hiring personnel, branch expansion, and advertising, which should be considered in a bank's deposit management program.

BANK MANAGEMENT OF DEPOSITS

A bank typically has an Asset Liability Committee (ALCO), which is responsible for managing market risk tolerances, establishing appropriate management information systems (MIS), reviewing and approving the liquidity and funds management policy, developing and maintaining a contingency funding plan, and reviewing immediate funding needs and sources. A major goal of an ALCO is to ensure that a bank has adequate liquidity while managing the bank's spread between interest income and interest expense.

In general, a bank's ALCO is responsible for developing and overseeing the bank's deposit management program. A deposit management program addresses the composition and volatility of the bank's deposit structure. An effective deposit management program includes

- regular reports detailing existing deposit types and levels;
- projections for asset and deposit growth;
- associated cost and interest rate scenarios;
- clearly defined marketing strategies to attract deposits;
- procedures to compare results against projections; and
- steps to revise the program as necessary.

Bank management should periodically review and make timely modifications to the deposit program that aligns with the bank's overall risk tolerance. When developing or modifying deposit management programs, bank management should generally consider

- the adequacy of current operations (staffing and systems);
- the location and number of bank branches relative to the bank's volume of business in a particular market;
- the degree of competition from other banks and nonbank financial institutions and their marketing programs to attract deposit customers; and
- the effects of the national economy and federal monetary and fiscal policies on the bank's service area.

The formality or complexity of a bank's deposit program depends on its activities and market composition. Bank management should closely monitor concentrations of deposits, particularly concentrations among customers who reside or conduct their business outside of the bank's normal service area. Such deposits may be the product of personal relationships or good customer service. However, large volumes of aggregate out-of-area deposits are sometimes attracted by less stringent lending criteria or significantly higher interest rates than those offered by competitors. 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 likely to remain at the bank (i.e., less stable). Deposit development and retention policies should recognize the limits imposed by prudent competition and the bank's service area.

DEPOSIT STRUCTURE AND VOLATILITY

The process of measuring liquidity risk should include robust methods for comprehensively projecting cash flows arising from assets, liabilities, and off-balance-sheet items over an appropriate time horizon.[1] In measuring a bank's overall liquidity risk, bank management should closely monitor the volume of deposits as well as the stability of the overall deposit structure. The volatility or stability of a bank's funding has a significant effect on how bank management should approach lending and investment activities. The stability of deposits is especially important in bank management's evaluation of available alternative sources of funds under adverse contingent liquidity scenarios.

Insured Deposits versus Uninsured Deposits

Deposit Insurance

One key factor in determining the stability of a bank's deposit structure is to assess the level of insured deposits versus uninsured deposits. The Federal Deposit Insurance Corporation (FDIC) protects depositors against the loss of their insured deposits in the event of a 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 Act (FDIA). The FDIC fully insures up to the standard maximum deposit insurance amount ($250,000, as of the effective date of this manual section) per depositor, per FDIC-insured bank, per legal ownership category. Information on FDIC insurance coverage for different deposit products is available on the FDIC public website.

One of the objectives of deposit insurance is to remove depositors' incentives to withdraw their deposits from their bank, which could result in a deposit run on a particular bank when questions about a bank's viability are raised. If a bank fails, insured depositors can be confident that they will have access to their insured deposits without interruption. As a result, insured deposits are generally fairly stable as these depositors do not have compelling reasons to withdraw their deposits from their bank, even if they expect other depositors to do so or if they believe their bank to be insolvent.

Uninsured Deposits

For most retail depositors, FDIC insurance fully insures the funds held in their deposit accounts. However, businesses and other organizations may hold deposits in excess of the standard maximum deposit insurance amount at a single bank, otherwise known as uninsured deposits. A bank that relies heavily on uninsured deposits to fund activities can encounter liquidity risks that can be very difficult to manage. Furthermore, large concentrations of uninsured deposits can exacerbate the potential for bank runs as depositors who are inadequately protected by FDIC insurance may consider moving their funds to another bank when they are concerned about the liquidity or solvency of their bank. In the modern banking environment, the technological advancements in banking afford customers the opportunity to move deposits from one bank to another bank with incredible speed. Once a bank run is underway, a bank has few options to stop the deposit outflow and correct any mismanagement of liquidity risk. If a bank run at one institution extends to bank runs at other institutions, the contagion effect can compromise overall financial stability.

In some cases, uninsured deposit relationships can represent a source of stable funding, provided the depositor has a longstanding relationship with the bank and the bank is in sound financial condition. However, such uninsured deposit relationships might become less stable if the bank experiences financial problems. As

1. SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management" (March 17, 2010). This SR letter was revised in August 2023 to attach an addendum reinforcing that depository institutions should maintain actionable contingency funding plans. See Addendum (August 1, 2023).

such, when conducting liquidity stress testing activities, a bank should consider and appropriately identify deposit accounts likely to be unstable in times of stress.

Core Deposits Versus Non-Core Deposits

Core deposits generally include stable, lower-cost funding sources that typically lag behind other funding sources in repricing during a period of rising interest rates. Core deposits are typically funds of local customers that also have a borrowing or other relationship with the bank. Several factors contribute to the stability of core deposits, such as the insured status of the account and the type of depositor (for example, retail, commercial, or municipal).

Core deposits are not defined by statute. Rather, the Uniform Bank Performance Report (UBPR) calculates core deposits as the sum of

1. All transaction accounts.
2. Money market deposit accounts (MMDAs).
3. Nontransaction other savings deposits (excluding MMDAs).
4. Fully insured time deposits (i.e., time deposits of $250,000 and less), less brokered deposits of $250,000 and less (i.e., fully insured brokered deposits).

The UBPR definition of core deposits represents an analytic starting point for assessing deposit volatility at banks. When analyzing the stability of deposit funding sources, UBPR accounts and ratios should be considered in light of the bank's balance sheet composition, risk profile, deposit stability trends, and other relevant and unique characteristics of the institution. In some instances, core deposit accounts may exhibit characteristics generally associated with more volatile funding sources and vice versa. For example, out-of-area certificates of deposit of $250,000 or less that are obtained from a listing service tend to be volatile even though this product would be considered a core deposit on the UBPR. From a supervisory perspective, brokered deposits generally are not considered core deposits or a stable funding source as they are generally highly rate-sensitive deposits and possess other wholesale deposit characteristics, such as high sensitivity to the credit rating of the bank.

Conversely, *noncore deposits* are generally viewed as less-stable funding sources, and include higher-cost, non-relationship deposits, such as internet deposits or deposits obtained through special-rate promotions. 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. Furthermore, volatile noncore deposits can be sensitive to adverse publicity and reputational concerns about the bank.

Deposit volatility can be a warning signal of emerging problems at a bank. Below are additional characteristics that distinguish volatile (noncore) from nonvolatile (core) deposits:

- type of depositor (e.g., individual, commercial, or municipal)
- length and nature of the banking relationship (e.g., reliance on multiple services or products such as loans, bill pay, or direct deposit)
- depositor's geographic location relative to the bank's market area (however, technology enables customers to easily bank without consideration of geographic location)
- historical pricing (interest rate change) associated with deposit relationships
- changes in the average balance over time
- effort expended by the bank to retain relationships
- insured versus uninsured balances in the deposit accounts

Brokered and High-Rate Deposits

Historically, most banks have not relied on funds obtained through deposit brokers to supplement their traditional funding sources. 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, brokered and high-rate deposits have long been a supervisory concern as such deposits pose various risks to banks. Without proper monitoring and management, brokered and other highly rate-sensitive deposits may be unstable sources of funding for a bank. An overarching 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. In addition, supervisors are concerned that such deposits can

- facilitate a bank's rapid growth in risky assets without adequate controls;
- be used by a bank to fund additional risky assets in an attempt to "grow out" of its problems, a strategy that ultimately could increase the losses to the FDIC's Deposit Insurance Fund if the bank were to fail;[2] and
- increase funding volatility because deposit brokers (on behalf of customers), or the customers themselves, are often drawn to high interest rates and are prone to leave the bank when they find a better rate, or they become aware of problems at the bank.

Definition of Deposit Broker

As defined in FDIC regulations, brokered deposits are funds a depository institution obtains, directly or indirectly, from or through the mediation or assistance of a deposit broker.[3] 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 FDIA (Section 29) and the FDIC's regulations define a *deposit broker* to mean

- any person engaged in the business of placing deposits of third parties with insured depository institutions,
- any person engaged in the business of facilitating the placement of deposits of third parties with insured depository institutions,
- any person engaged in the business of placing deposits with insured depository institutions for the purpose of selling those deposits or 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.[4]

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,[5] 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 U.S.C. 401(d), 503(a));
- an agent or a nominee whose primary purpose is not the placement of funds with depository institutions;[6]

2. 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.

3. See 12 CFR 337.6(a)(2). Section 29 of the FDIA does not explicitly define the term "brokered deposit." Restrictions on brokered deposits are tied to the statutory definition of "deposit broker" that Congress adopted in 1989 as part of the legislative response to the bank and thrift crisis of the late 1980s, and the FDIC's regulations and interpretations of the term.

4. 12 U.S.C. 1831f(g)(1); 12 CFR 337.6(a)(5).

5. 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.

6. In January 2021, the FDIC issued a final rule on brokered deposits and interest rate restrictions (Final Rule). See 86 Fed Reg. 6742 (January 22, 2021). Notably, this rule narrows and clarifies the FDIC's prior interpretations of the "deposit broker" definition in its rules and broadens exclusions from the definition. The FDIC's Final Rule clarifies that the primary purpose exception applies when the primary purpose of the agent's or nominee's business relationship *with its customers* is not the placement of funds with insured depository institutions and designates certain business relationships as presumptively meeting the primary purpose exception with respect to a particular business line. The Final

- 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; or
- any person that receives/facilitates third-party funds and deposits them at a *single* insured depository institution.[7]

Brokered Deposit Limitations and Interest Rate Restrictions

To compensate for the high rates typically offered for brokered deposits, banks holding the deposits tend to seek assets that carry commensurately higher 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 its assets versus its liabilities. As such, the acceptance of brokered deposits is subject to statutory and regulatory restrictions.

Section 29 includes certain restrictions on the use of brokered deposits to generally prohibit insured depository institutions that are not well capitalized from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts.[8] Adequately capitalized banks may only accept brokered deposits upon receiving a waiver from the FDIC, and banks that are undercapitalized may not accept them at all.[9] The definitions of well capitalized, adequately capitalized, and undercapitalized align with the prompt corrective action (PCA) statutes, as implemented by the Federal Reserve in subpart D to Regulation H.[10] For more information on the PCA capital categories, see this manual's section entitled, "Prompt Corrective Action."

Although Section 29 does not place restrictions on the rate of interest that well capitalized institutions can pay on deposits, the statute imposes different interest rate restrictions on different categories of insured depository institutions that are less than well capitalized. Section 29 prohibits such banks from paying rates on deposits that significantly exceed their normal market area or the national rate as established by the FDIC by regulation.[11] Statutory and regulatory deposit rate restrictions prevent a bank that is not well capitalized from circumventing the prohibition on brokered deposits by offering rates significantly above market in order to attract a large volume of deposits quickly. However, the statute imposes different interest rate restrictions on different categories of insured depository institutions that are adequately capitalized. Table 1 provides a high-level summary of the brokered deposit and interest rate restrictions in the FDIC's regulations.

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.[12] The advisory sets forth risk-management guidelines for brokered deposits. A bank's management is expected to implement risk-management systems that are commensurate in complexity with the bank's liquidity and funding risks. Effective risk-management systems incorporate the following principles:

- *Proper funds-management policies*. An effective policy should generally provide for forward planning, establish an appropriate cost structure, and set realistic limitations and business strategies. The policy should clearly convey the board's risk tolerance and should clearly explain who holds responsibility for funds-management decisions.
- *Adequate due diligence when assessing deposit brokers*. Bank management should implement adequate due diligence procedures before entering into 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 man-

Rule also allows insured depository institutions and third parties that wish to use the primary purpose exception but that do not meet one of the designated exceptions to apply for a primary purpose exception. Prior to the FDIC's Final Rule, the FDIC had taken a case-by-case approach to the primary purpose exception.

7. The FDIC's Final Rule clarified this exception and codified it at 12 CFR 337.6(a)(5)(ii), (iii).

8. 12 U.S.C. 1831f(a).

9. 12 U.S.C. 1831f(c).

10. 12 CFR 208.40–208.45. See this manual's section entitled, "Prompt Corrective Action."

11. 12 U.S.C. 1831f(e).

12. See Joint Agency Advisory on Rate-Sensitive Deposits, SR-01-14 (May 31, 2001).

Table 1. Brokered deposits and interest rate restrictions

PCA capital category of insured depository institution (IDI)	**Brokered deposit restrictions (12 CFR 337.6(b))**	**Interest rate restrictions (12 CFR 337.7(c))**
Well capitalized	None. An IDI may solicit and accept, renew, or roll over any brokered deposit without restriction by rules pertaining to brokered deposits.	None. An institution may pay interest without restriction by rules pertaining to brokered deposits.
Adequately capitalized	An IDI 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.	An IDI may not solicit deposits by offering a rate of interest that exceeds the applicable rate cap. Where an IDI has accepted brokered deposits pursuant to a waiver by the FDIC, the IDI may not pay an interest rate that, at the time such deposit is accepted, exceeds the applicable rate cap.[1]
Undercapitalized	An IDI may not accept, renew, or roll over any brokered deposit.	Not applicable.

1. For purposes of 12 CFR 337, the applicable rate cap is the national rate cap or, if the institution has provided the notice and evidence described in 12 CFR 337.7(d), the local market rate cap for deposits gathered in the institution's local market area. If an institution gathers deposits from more than one local area, it may seek to pay a rate of interest up to its local market rate cap for deposits gathered in each respective local market area.

age highly sensitive funding sources carefully, avoiding excessive reliance on funds that may be only temporarily available to the bank or which may require premium rates to retain.

- *Reasonable control structures to limit funding concentrations*. Deposit 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.
- *MIS that clearly identifies non-relationship or higher-cost funding programs which should allow management to track performance, manage funding gaps, and monitor compliance with concentration and other risk limits*. Effective MIS includes a listing of funds obtained through each significant deposit 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 should also correctly report brokered deposits in the bank's Call Report.[13]
- *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 consider possible market reaction if the bank were to reduce its interest rates on rate-sensitive deposits. The potential for triggering legal limitations that restrict the bank's access to brokered deposits under PCA standards, and the effect that this would have on the bank's liability structure, should also be factored into the plan.

13. See the FFIEC Bank Call Report and Instructions for Consolidated Reports of Condition and Income, Schedule RC-E, Deposit Liabilities.

OTHER TYPES OF DEPOSITS AND DEPOSIT PROGRAMS

Reciprocal Deposits

Banks can participate in networks that effectively permit their customers to receive full FDIC insurance while placing deposit balances of more than $250,000 in a single account at the same bank. The FDIA and the FDIC's regulations define "reciprocal deposits" as "deposits received by an agent institution through a deposit placement network with the same maturity (if any) and in the same aggregate amount as covered deposits placed by the agent institution in other network member banks."[14] A bank that the FDIC considers an "agent" institution is allowed to report a certain amount of reciprocal deposits as non-brokered deposits. Any one of the following three situations allows a bank to report reciprocal deposits as non-brokered deposits:

1. The bank has a composite rating that is satisfactory or better and is well capitalized.
2. The bank has a waiver from the FDIC.
3. The bank has a total amount of reciprocal deposits that does not exceed the average total of reciprocal deposits the bank held on the last day of the four quarters preceding the calendar quarter the institution was found to be in less than satisfactory condition or less than well capitalized. This is referred to as the "special cap."

The Call Report provides more information on reporting reciprocal deposits as well as definitions for "covered deposits," "deposit placement networks," and "network member banks." There are several risks associated with reciprocal deposits as a funding source, including, among other things:

- If a bank inappropriately reports reciprocal deposits as non-brokered deposits when they should be categorized as brokered deposits (e.g., because they exceed the statutory limit), the bank's contingency funding plan may not accurately represent how potential brokered deposit restrictions can affect the bank in a stress scenario.
- Depending on the relationship that depositors have with their relationship banks, reciprocal deposits may still have volatile qualities similar to brokered deposits and could expose a bank to heightened funding risks in a stress scenario.

Banks should understand the relationships tied to reciprocal deposits to assess their stability. Furthermore, contingency funding plans should appropriately consider how reciprocal deposits might behave in various situations.

14. 12 U.S.C. 1831f(i)(2)(E); 12 CFR 337.6(e)(2)(v). For more information on an "agent institution" see 12 U.S.C. 1831f(i)(2).

Treasury Tax and Loan Accounts

Treasury Tax and Loan accounts (TT&L accounts) are maintained at banks by the U.S. Treasury to facilitate payments of federal withholding taxes. Banks may select either the "remittance-option" or the "note-option" method of forwarding deposited funds to the U.S. Treasury.

- In the remittance option:
  - — The bank remits the TT&L account deposits to the Federal Reserve Bank the next business day after deposit.
  - — The remittance portion is not interest-bearing.
- In the note option:
  - — The bank retains the TT&L deposits.
  - — The bank debits the TT&L remittance account for the amount of the previous day's deposit and simultaneously credits the note-option account.
  - — Note-option accounts are interest-bearing and can grow to a substantial size.

TT&L funds are considered purchased funds, evidenced by an interest-bearing, variable-rate, open-ended, secured note callable on demand by Treasury. Pursuant to 31 CFR 203.24, the TT&L balance requires pledged collateral, usually from the bank's investment portfolio. Because they are secured, TT&L balances reduce standby liquidity from investments, and because they are callable, TT&L balances are considered to be volatile and they must be carefully monitored. However, in most banks, TT&L deposits constitute only a small portion of total liabilities.

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 a bank.

A bank's 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 a 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 manual intervention and the exception nature of these transactions, the possibility exists that these funds may be misappropriated.

Official checks, a type of demand deposit, include bank checks, cashier's checks, certified checks, and money orders. Official checks reflect a bank's promise to pay a specified sum upon presentation of these official bank 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 bank functions that originate these types of checks. Operational inefficiencies, such as unrecorded checks that have been issued, can result in a significant understatement of a bank's liabilities. Misuse or theft of official checks may result in substantial losses to a bank.

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

A bank should implement appropriate policies and processes to properly administer and control such accounts. Effective policies establish

- acceptable purposes and uses;
- appropriate entries; and
- limits on the length of time an item may remain unrecorded, unposted, or outstanding.

An effective deposit program provides for internal controls that

- limit employee access to bank-controlled accounts;
- determine the responsibility for frequency of reconcilement of an account;
- discourage improper posting of items; and
- provide for periodic internal review of account activity.

Employee Deposit Accounts

Employee deposit accounts are a potential source of irregularities and potential malfeasance. As a result, a bank should implement processes that segregate or specially encode employee accounts and should conduct periodic internal reviews of such accounts.

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 bank 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.

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 with a high reliance on public funds as a percentage of total deposits can cause potential liquidity concerns. Another factor that can cause potential liquidity concerns relates to the volatile nature of public fund 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 the following key points:

1. The safety and soundness of the institution with which the funds have been placed.
2. The yield on the funds being deposited.
3. Whether the bank can provide or arrange the best banking service at the least cost to the government entity.

Additionally, a government entity also considers whether a bank can offer competitive interest rates and provide collection, financial advisory, underwriting, and data processing services at competitive costs. Public funds deposits acquired through political influence should be regarded as particularly volatile.

A bank's failure to identify, measure, control, and monitor the risks associated with concentrations of public funds deposits and to monitor compliance with collateral protection requirements may raise supervisory concerns about a bank's liquidity risk. Collateral protection requirements become particularly relevant as a bank's condition changes or deteriorates. Asset quality deterioration or financial underperformance could preclude a problem bank from acquiring or retaining public funds. Individual states can have heightened collateral protection requirements for public funds on deposit in problem banks. If a bank is unable to meet the requirements, the bank will be required to close the deposit account and return the funds to the depositor.

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 the corporate customers will deposit funds into the account to cover the checks before the end of the banking day.

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.

Overdraft Protection Programs

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 an 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. Overdrafts outstanding for more than 60 days, lacking mitigating circumstances, should be considered for charge-off. See SR-05-3/CA-05-2, "Interagency Guidance on Overdraft Protection Programs" (February 23, 2005) and this manual's section entitled, "Consumer Credit."

Deposit Sweep Programs or Master-Note Arrangements

Deposit sweep programs or master-note arrangements (sweep programs) use an agreement with a 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 (BHC), another affiliate of the bank, or a third party. These obligations include instruments, such as commercial paper, program notes, and master-note agreements.

Sweep programs can be implemented on a bank level or on a parent 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 up-streamed to the parent as part of the BHC's funding strategy.

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 ensure that the bank provides deposit customers participating in a sweep program with proper disclosures and information.

For more information on sweep programs, see SR-90-31, "Bank Holding Company Funding from Sweep Accounts" as well as section 2080.6 of the *Bank Holding Company Supervision Manual*.

COMPLIANCE CONSIDERATIONS ASSOCIATED WITH DEPOSITS

Abandoned-Property Law and 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. State abandoned-property laws generally are called escheat laws. Although escheat laws vary from state to state, these state laws normally require a bank to remit the funds in a 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 not be excessive and generally should reflect the cost of servicing the accounts. A bank's board of directors (or a committee appointed by the board) should periodically review bank policies that address service charges on dormant accounts. Because of the risks associated with dormant accounts, bank management should implement policies and control procedures, 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.

Reserve Requirements (Regulation D)

Section 19 of the Federal Reserve Act (FRA) requires the Board to impose reserve requirements on certain deposits and other liabilities of depository institutions within limits specified in the FRA.[15] "Depository institutions" include banks, savings associations, savings banks, and credit unions as well as institutions that are federally insured and those that are eligible to apply for federal deposit insurance. Regulation D implements the reserve requirements of section 19 of the FRA, sets forth related reporting requirements, and authorizes the payment of interest on balances maintained by eligible institutions in accounts at Federal Reserve Banks.[16]

In March 2020, the Board reduced all reserve requirements to zero percent. Accordingly, depository institutions are not required to satisfy reserve requirements. Regulation D also sets forth definitions of certain types of deposits that must be reported by depository institutions and identifies the obligations of institutions to file reports of deposits. In addition, Regulation D specifies the rate of interest that is paid on balances of eligible institutions in accounts at Federal Reserve Banks. For more information, see the Regulation D Compliance Guide to Small Entities.

15. 12 U.S.C. 461.
16. 12 CFR 204. Regulation D also implements section 7 of the International Banking Act of 1978 (12 U.S.C. 3105), which imposes reserve requirements on certain U.S. branches and agencies of foreign banks to the same extent as depository institutions.

Bank Secrecy Act (Regulation H)

The Bank Secrecy Act (BSA) establishes reporting requirements for banks' deposit activity. For example, a bank must electronically file a Currency Transaction Report (CTR) for certain transactions in currency, which include deposits, withdrawals, exchanges of currency, or other payments or transfers. The BSA is implemented by the Treasury Department's Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see

- The Board's Regulation H (12 CFR 208.63);
- This manual's section entitled, "Regulation H: Bank Secrecy Act and Anti-Money-Laundering";
- The *FFIEC Bank Secrecy Act Examination Manual*; and
- The Financial Crimes Enforcement Network (FinCEN)'s BSA regulations at 31 CFR Chapter X.

Banks should be aware that there are varying degrees of risk associated with the treatment of accounts for foreign governments, foreign embassies, and foreign political figures. Further guidance on this topic can be found in

- SR-04-10, "Banking Accounts for Foreign Governments, Embassies, and Political Figures" (June 16, 2004); and
- SR-11-6, "Guidance on Accepting Accounts from Foreign Embassies, Consulates and Missions (foreign missions)" (March 24, 2011).

These guidance issuances explain that banking organizations should take appropriate steps to manage such risks consistent with sound practices and applicable anti-money-laundering laws and regulations. In particular, SR-11-6 clarifies information specific to banking organizations providing account services to foreign embassies, consulates and missions in a manner that fulfills the banking service needs of foreign governments while complying with the provisions of the BSA. As is the case with all accounts, a bank should demonstrate the capacity to conduct appropriate risk assessments and implement the requisite controls and oversight systems to effectively manage varying degrees of risks in financial relationships with foreign missions.

Overdrafts (Regulation O)

Overdrafts paid by a bank to its insiders are subject to two sets of requirements in the Board's Regulation O.[17] First, an overdraft is a type of "extension of credit" for purposes of the Board's Regulation O and thus is subject to the quantitative and qualitative requirements in that rule, including that large overdrafts must be approved in advance by a bank's board of directors.[18] Second, Regulation O prohibits a bank's payment of an overdraft for an executive officer or director.[19] However, overdrafts that meet certain criteria are not subject to these restrictions.[20]

Availability of Funds and Collection of Checks (Regulation CC)

Regulation CC Overview

Regulation CC (12 CFR 229), as amended, implements two laws—the Expedited Funds Availability Act (EFA Act) and the Check Clearing for the 21st Century Act (Check 21). The regulation requires banks to make funds deposited into transaction accounts available according to specified time schedules and to disclose funds availability policies to customers. The regulation also establishes rules designed to speed the collection and return of checks and electronic checks and describes requirements when a bank creates or receives substitute checks, including requirements related to consumer disclosures and expedited recredit procedures.

For more information on Regulation CC, see

- Compliance with Regulation CC: A Guide for Financial Institutions;

17. See generally 12 CFR 215. An "insider" is a director, executive officer, principal shareholder, or related interest of such persons. See also 12 CFR 215.2(h)

18. Most requirements for extensions of credit are set forth in 12 CFR 215.4. The prior approval requirement is set forth in 12 CFR 215.4(b).

19. See 12 CFR 215.4(e). The prohibition against overdrafts does not apply to overdrafts paid to a related interest of an executive officer or director.

20. Certain overdrafts are excepted from the definition of "extension of credit." See 12 CFR 215.3(b)(2) and (6). A similar but not identical set of overdrafts are not subject to the prohibition on overdrafts to executive officers and directors. See 12 CFR 215.4(e)(1)(i)–(ii) and (e)(2).

- The Federal Reserve's *Consumer Compliance Handbook*; and
- CA-18-8, "Revised Interagency Examination Procedures for Regulation CC" (October 17, 2018).

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 a bank to collect funds from the paying bank; and
- the depositor initiates the transaction with the knowledge that the depositor has insufficient funds to cover the amount of the checks drawn on all the depositor's accounts.

The key to this deceptive practice, a 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 depositor's aggregate amount of drawings exceeds the sum of the collected balances in all the depositor's accounts. Since drawing against uncollected funds is the initial step in the kiting process, management should closely monitor this type of deposit activity and maintain internal controls to mitigate the potential loss. Therefore, 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.

Regulation CC provides for exceptions that allow banks to exceed the maximum hold periods specified in the availability schedule. The exceptions are considered "safeguards" because they offer institutions a means of reducing risk based on the size of the deposit, the depositor's past performance, the absence of a record on the depositor's past performance, or a belief that the deposit may not be collectible. One exception includes cases in which the bank has reasonable cause to believe the check being deposited is uncollectible. The reasonable-cause exception may also be invoked in cases in which the depositary bank believes that the depositor may be engaged in check kiting.

Delayed Disbursement Practices

Regulation CC stipulates time frames for funds availability and return of items. However, delayed disbursement practices (also known as remote disbursement practices) are used by a bank to address certain risks, especially concerning cashier's checks, which have next-day availability of funds. Delayed disbursement is a common cash management practice that consists of arrangements designed to delay the collection and final settlement of checks drawn on institutions located substantial distances from the payee.

Delayed disbursement arrangements could give rise to credit risks:

1. Delayed disbursement arrangements often increase the collection time for checks.
2. Payment against uncollected funds could be a method of extending unsecured credit to a depositor.
   a. absent of proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice.
3. Furthermore, payment against uncollected funds, even if properly documented, might exceed the bank's legal lending limit for loans to one customer.

SUPERVISORY CONSIDERATIONS

SR-96-38, "Uniform Financial Institutions Rating System" (December 27, 1996), provides guidance on assigning ratings for depository institutions, which includes the liquidity position. In evaluating the adequacy of a depository institution's liquidity position, examiners should consider the current level and prospective sources of liquidity compared to funding needs, as well as the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. Among other factors, examiners' assessment of liquidity should also consider

- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer term assets; and
- the trend and stability of deposits.

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 noncore deposits and core deposits. To guide the assessment of a bank's deposit structure and deposit volatility, examiners should reference the "Liquidity" Examination Documentation (ED) module. In general, examiners should

- assess the ability of bank management to identify, measure, and monitor deposit volatility;
- determine whether management considers the stability of deposit accounts and significant customer relationships and reflects them accordingly in the bank's liquidity monitoring and reporting systems;
- determine whether the bank's liquidity stress scenarios are conducted across multiple time horizons, use reasonable modeling assumptions under various stress scenarios, and are commensurate with the bank's complexity and level of risk exposure that consider (among other things) availability of liquidity, given potential haircuts on borrowings, FHLB restrictions, deposit runoff;
- review the various types of deposit accounts that the bank uses for its funding base;
- determine whether the bank complies with statutes and regulations that apply to deposit accounts; and
- analyze the present and potential effect deposit accounts have on the bank's earnings by reviewing
  - — 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; and
  - — promotional and advertising costs.

Given the potential risks involved in using brokered deposits, examiners should review banks' management of brokered or other rate-sensitive deposits. 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 regarding the use of these funding sources. Examiners should refer to the "Brokered and High-Rate Deposits" ED module for further analysis of material exposure to brokered deposits and less stable or rate-sensitive funding sources. Examination work on assessing brokered deposits 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 asset 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, plan, 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 following represent potential supervisory concerns that may indicate unsafe and unsound banking practices associated with brokered or other rate-sensitive funding sources:

- 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 interest 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; and
- other conditions or circumstances warranting the need for administrative action.

If examination staff determine that a bank's use of funding sources is not safe and sound, or that the 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.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED modules for examination procedures on this topic:

- Liquidity
- Other Assets and Liabilities

INTRODUCTION

Bank premises and equipment includes land, buildings, furniture, fixtures, and other equipment, either owned or acquired by means of a capitalized lease, and any leasehold improvements. This section covers the fair valuation, general propriety, and legality of the bank's investment in premises and equipment. Other real estate owned and insurance coverage on fixed assets are discussed in other sections of this manual.

ACQUISITION AND VALUATION

Banks obtain premises and equipment in three primary ways:

- directly purchasing premises and equipment with cash outlays or by incurring debt, such as a mortgage;
- indirectly investing in a corporation that holds title to bank premises (the corporation may or may not be affiliated with the bank); or
- leasing bank premises and equipment from a third party

The bank's initial investment in premises and equipment should be booked at cost, which should be determined according to generally accepted accounting principles (GAAP). Nondepreciable assets such as land and art should remain on the books at cost, unless the asset incurs a material and permanent decline in value. Under such circumstances, the asset should be reduced to its fair value on the books, and a loss should be recorded.

The bank should depreciate assets that, over time, decline in economic value. These assets may be depreciated differently for book and tax purposes, which may give rise to deferred tax assets and deferred tax implications. GAAP allows depreciation using various methods. These include time-factor methods such as straight-line and accelerated methods. Accelerated methods include sum-of-the-years' digits depreciation, declining-balance depreciation, double-declining-balance depreciation, and other accelerated methods. The Internal Revenue Service allows accelerated depreciation methods for many assets to encourage businesses to make capital investments. While many banks follow these accelerated schedules for tax purposes, they may not depreciate these same assets as rapidly for book purposes.

Examiners should review internal controls for the bank's premises and equipment to ensure that these assets are properly safeguarded and appropriately recorded on the bank's books. Controls should be in place to inventory these assets and address the periodic review of their economic usefulness. Furniture, fixtures, and equipment whose economic usefulness have expired or that are otherwise damaged, impaired, or obsolete should be written down to value. Assets that cannot be located should be accounted for as a loss.

LEASES

Banks frequently lease their premises and equipment rather than own them. Leases should be accounted for appropriately. In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-02, "Leases (Topic 842)," which supersedes Accounting Standards Codification (ASC) 840.[1] Entities that have not adopted ASU 2016-02, should continue to account for leases in accordance with ASC Topic 840, Leases. Entities that have adopted ASU 2016-02, should account for leases in accordance with ASC Topic 842, Leases.

The instructions, including the supplemental instructions, for the preparation of the Call Report detail the capitalization of leases and specify treatment for leases. The accounting requirements for leasing transactions are somewhat complex, and examiners who have ques-

1. ASU 2016-02 is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years, for banks that are public business entities (PBEs). For banks that are not PBEs, the guidance is effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 31, 2020. For further information, see the Glossary entries in the Call Report Instructions for "public business entity" and "private company." Early adoption is permitted for all banks. An institution that early adopts these standards must apply them in their entirety. If an institution chooses to early adopt these standards for financial reporting purposes, the institution should implement them in its FFIEC Consolidated Reports of Condition and Income (Call Report) for the same quarter-end report date.

tions on the capitalization of leases should refer to the applicable ASC Topic for necessary detail.

Lease arrangements between a state member bank and its parent company or other affiliated entity should be reviewed in detail. Examiners should consider whether the lease arrangement is reasonable in relation to the cost of the asset, its current fair value, or similar lease arrangements in the current market. Transactions that appear to be self-serving or otherwise unreasonable to the bank should be criticized.

APPLICATION PROCEDURES FOR INVESTING IN BANK PREMISES

Section 24A of the Federal Reserve Act (12 USC 371d) requires state member banks to obtain Federal Reserve System approval to make additional investments that would cause the bank's total bank premises investments to exceed certain percentage-of-capital thresholds. Section 208.21 of Regulation H implements this requirement. Note that for purposes of this requirement, "bank premises investments" include a bank's direct investment in premises; its investment in the stock (or other ownership interests), bonds, debentures, or other such obligations of any company holding the premises of the bank; and loans made to (or on security of) any company holding the premises of the bank.

A bank that is well-capitalized (as defined in Regulation H) and has a CAMELS composite rating of 1 or 2 (as of its most recent examination) must obtain prior Federal Reserve System approval for a bank premises investment only if the investment would cause the bank's total bank premises investments (plus any debt incurred by any bank premises company affiliated with the bank) to exceed 150 percent of the bank's perpetual preferred stock (and related surplus) plus its common stock (and related surplus).

A bank not eligible for the 150 percent threshold must obtain prior Federal Reserve System approval for a bank premises investment only if the investment would cause the bank's total bank premises investments (plus any debt incurred by any bank premises company affiliated with the bank) to exceed the bank's perpetual preferred stock (and related surplus) plus its common stock (and related surplus).

To make a bank premises investment that exceeds the applicable threshold, a bank must notify the Federal Reserve of the proposed investment at least 15 days before making it, and must not have been advised by the Federal Reserve prior to the end of the 15-day period that the investment is subject to further review.

Approval is not required under Section 24A where a change in U.S. GAAP requires a state member bank to capitalize premises leased prior to the effective date of the new accounting standard. Thus, if prior to adoption of the new accounting standard a state member bank's investment in bank premises is less than capital stock, but that investment increases to an amount in excess of capital stock by virtue of adopting the new accounting standard, the bank need not seek the Board's approval under Section 24A. However, approval will be required under Section 24A for any bank premises investment in excess of capital stock made following adoption of ASU 2016-02.[2]

Section 208.6(b) of Regulation H provides factors that the Board will consider in approving domestic-branch applications. One of the factors the Board will analyze is whether the bank's investment in premises for the branch is consistent with section 208.21 of Regulation H. Reserve Banks, under their delegated authority, can also perform this analysis.

FUTURE USE AND CLASSIFICATION AS OREO

Member banks are encouraged to plan for their future premises needs. However, examiners should not arbitrarily classify real estate acquired for future use. The examiner needs to review the circumstances surrounding each individual case and determine if the period of time which the property has been held is reasonable relative to the intended use. Real estate acquired for future expansion is considered "other real estate owned" from the date when its use for banking is no longer contemplated. In addition, former banking premises are considered other real estate owned as of the date the bank relocated to new banking quarters.

2. See SR letter 19-7, "Statement on the Implications of the New Lease Accounting Standard on Regulation H," for more information.

TRANSACTIONS WITH INSIDERS

If a member bank contracts for or purchases any securities or other property from any of its directors, any firm its directors are members of, or any of its affiliates, the transaction is subject to the requirements of section 23B of the Federal Reserve Act and the Board's Regulation W. These sections require that transactions be made in the regular course of business on terms not less favorable to the bank than those offered to others. When the purchase is authorized by a majority of the board of directors who have no interest in the sale of such securities or property, the authority should be evidenced by affirmative vote or written assent. In addition, a member bank may sell securities or other property to any of its directors subject to the same stipulations.

EXAMINATION CONSIDERATIONS

As indicated earlier, the examiner responsible for the review of bank premises and equipment should assess the appropriateness of the bank's investment in this area and the overall impact of occupancy expense on the bank. Even if a bank's total investment in bank premises is within state or federal regulatory limits and all of its fixed assets are valued fairly, its total expenditures for or investment in premises and equipment may be inappropriate relative to the bank's earnings, capital, or the nature and volume of the its operations.

1. To determine whether the policies, practices, procedures, and internal controls regarding bank premises and equipment are adequate.
2. To determine whether bank officers and employees are operating in conformance with the bank's established guidelines.
3. To determine the scope and adequacy of the audit function.
4. To determine the adequacy and propriety of the bank's present and planned investment in bank premises.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

1. Evaluate policies and procedures regarding premises and fixed assets. Satisfactory internal policies generally address items such as
   - requirements that the directorate approve all major purchases;
   - guidelines that discourage conflicts of interest or self-dealing with vendors, servicers, and insurers; and
   - guidelines for maintaining the level and nature of premises and fixed asset investments in compliance with applicable laws and regulations (e.g., state laws and Section 24A of the Federal Reserve Act).
2. Evaluate internal controls. Consider whether
   - individuals who post purchase and sale records are responsible for the custody or inventory of the property;
   - subsidiary ledgers of depreciation are balanced to the general ledger by persons who have sole custody of property;
   - periodic physical inventories confirm asset values;
   - adequate fire and extended insurance coverage is in force for bank premises, furniture, and equipment;
   - asset sales, including the recognition of gains and losses, are appropriately recognized; and
   - disclosures, including the existence of liens, are appropriate.
3. Determine whether investment in premises and equipment is reasonable and in compliance with state laws:
   - Review the current and prospective use of fixed assets in serving banking needs.
   - Review Uniform Bank Performance Report schedules to determine if investments in premises and fixed assets are reasonable in relation to total assets and consider the percentage of operating income absorbed by occupancy expense.
4. Determine whether audit procedures consider premises and equipment that are held by the bank, a subsidiary, or an affiliate realty corporation as part of sale and leaseback transactions or as lease-purchase contracts:
   - If significant, auditors should ensure capitalized lease designations are appropriate and in accordance with GAAP.
   - If part of sale-leaseback agreement, they should review for proper accounting treatment and accordance with GAAP.
5. Determine whether information and reporting regarding fixed assets to senior management and the board is adequate.
6. Determine whether real estate held for future expansion still qualifies as bank premises.
7. Reconcile premises and equipment subsidiary ledgers to the general ledger.

An internal control questionnaire (ICQ) helps an examiner assess a bank's internal controls for an area. ICQs typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update ICQs during examination planning or after reviewing the findings and conducting preliminary examination activities. Items marked with an asterisk require substantiation by observation or testing.

CUSTODY OF PROPERTY

*1. Do the bank's procedures preclude persons who have access to property from having "sole custody of property," in that
   a. Its physical character or use would make any unauthorized disposal readily apparent?
   b. Inventory control methods sufficiently limit accessibility?

ACQUISITIONS, SALES, AND DISPOSALS

2. Is the addition, sale or disposal of property approved by the signature of an officer who does not also control the related disbursement or receipt of funds?
3. Is board of directors' approval required for all major additions, sales or disposals of property (if so, determine the amount that constitutes a major acquisition, sale or disposal)?

*4. Is the preparation, addition, and posting of property acquisitions, sales, and disposals records, if any, performed and/or adequately reviewed by persons who do not also have sole custody of property?

*5. Do persons who do not also have sole custody of property balance any property acquisition, sale, or disposal records, at least quarterly, to the appropriate general ledger?

6. Are the bank's procedures such that all acquisitions are reviewed to determine whether they represent replacements and that any replaced items are cleared from the accounts?
7. Do the bank's procedures provide for signed receipts for removal of equipment?

*8. Do the bank's policies cover procedures for selecting a seller, servicer, insurer, or purchaser of major assets (for example, through competitive bidding) to prevent any possibility of conflict of interest or self-dealing?

9. Do the review procedures provide for appraisal of an asset to determine the propriety of the proposed purchase or sales price?

DEPRECIATION

*10. Is the preparation, addition, and posting of periodic depreciation records performed and adequately reveiwed by persons who do not also have sole custody of property?

11. Do the bank's procedures require that regular charges be made for depreciation expense?

*12. Do persons who do not also have sole custody of property balance subsidiary depreciation records, at least quarterly, to the appropriate general ledger controls?

PROPERTY RECORDS

*13. Are subsidiary property records posted by persons who do not also have sole custody of property?

*14. Do persons who do not also have sole custody of property balance the subsidiary property records, at least quarterly, to the appropriate general ledger accounts?

BANK AS LESSOR (BANK PREMISES AND BANK-RELATED EQUIPMENT ONLY)

*15. Do policies provide for division of the duties involved in billing and collection of rental payments?

16. Are the lease agreements subject to the same direct verification program applied to other bank assets and liabilities?
17. Are credit checks performed on potential lessees?
18. Do policies provide for a periodic review of lessees for undue concentrations of affiliated or related concerns?

BANK AS LESSEE (BANK PREMISES AND BANK-RELATED EQUIPMENT ONLY)

19. Does the bank have a clearly defined method of determining whether fixed assets should be owned or leased, and is supporting documentation maintained by the bank?
20. Are procedures in effect to determine lease classification as defined by the generally accepted accounting principles?
21. Do the bank's operating procedures provide, on capitalized leases, that the amount capitalized is computed by more than one individual and/or reviewed by an independent party?

OTHER PROCEDURES

*22. Is the physical existence of bank equipment periodically checked or tested, such as by a physical inventory, and are any differences from property records investigated by persons who do not also have sole custody of property?

23. Do the bank's procedures provide for serial numbering of equipment?
24. Are the bank's policies and procedures on property in written form?
25. Is the benefit of expert tax advice obtained prior to final decision-making on significant transactions involving fixed assets?

*26. Does the bank maintain separate property files, which include invoices (for example, settlement sheets and bills of sale), titles on real estate and vehicles, Uniform Commercial Code (UCC) filings or liens for personal property, and other pertinent ownership data?

CONCLUSIONS

27. Is the foregoing information an adequate basis for evaluating internal control in that there are no significant additional deficiencies that impair any controls? Explain negative answers briefly, and indicate any additional examination procedures deemed necessary.
28. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

A state member bank's authority to hold real estate is governed by state law. A bank is permitted to include owned real estate in its premises account if the real estate serves as premises for operations or is intended to be used as premises. In addition, a bank may hold other real estate owned (OREO), which is defined below. State laws dictate the terms and conditions under which state-chartered banks may acquire and hold OREO.

The bank's policies and procedures should address the management and disposition of its OREO holdings, including

- protection of a bank's interests in a property,
- account for the OREO asset and expenses associated with the maintenance and disposition of the property in conformance with generally accepted accounting principles and Call Report Instructions, and
- compliance with federal and state laws pertaining to the holding of OREO.

DEFINITION

Other real estate comprises all real estate, other than bank premises, owned or controlled by the bank or its consolidated subsidiaries, including real estate acquired through foreclosure, even if the bank has not received title to the property. Bank holdings of OREO may arise from the following events:

- the bank purchases real estate at a sale under judgment, decree, or mortgage when the property secured debts previously contracted;
- a borrower conveys real estate to the bank to fully or partially satisfy a debt previously contracted (acceptance of deed in lieu of foreclosure);
- real estate is obtained in exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- a bank takes possession (although not necessarily title) of collateral in a collateral-dependent real estate loan (i.e., an in-substance foreclosure);
- a bank has relocated its premises and has not yet sold the old premises;
- a bank abandons plans to use real estate as premises for future expansion; and
- a bank has foreclosed real estate that is under contract for sale.

There are three major phases of the OREO life cycle: acquisition, holding period, and disposition.

ACCOUNTING AND REPORTING STANDARDS

The accounting and reporting standards for the acquisition phase are set forth in Accounting Standards Codification (ASC) 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings"); ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets"); and ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement. Until the effective date of Accounting Standards Update (ASU) 2014-09[1] "Revenue from Contracts with Customers," which includes amendments to ASC Subtopic 610-20, Other Income–Gains and Losses from the Derecognition of Nonfinancial Assets, the primary accounting guidance for sales of foreclosed real estate is ASC Subtopic 360-20, Property, Plant, and Equipment – Real Estate Sales (formerly FASB Statement No. 66, "Accounting for Sales of Real Estate"). When it takes effect, ASC Subtopic 610-20 supersedes ASC Subtopic 360-20 for real estate sales not

1. Effective date of ASU 2014-09, including ASC Subtopic 610-20 (and ASC Topic 606) – For institutions that are public business entities, these standards are effective for fiscal years beginning after December 15, 2017, including interim reporting periods within those fiscal years. For institutions that are not public business entities (i.e., that are private companies), the standards are effective for fiscal years beginning after December 15, 2018, and interim reporting periods within fiscal years beginning after December 15, 2019. For further information, see the Glossary entries in the Call Report Instructions for "public business entity" and "private company." Early application of these standards is permitted for all institutions for fiscal years beginning after December 15, 2016, and interim reporting periods as prescribed in the standards. An institution that early adopts these standards must apply them (including all of ASC Topic 606 on revenue recognition) in their entirety. If an institution chooses to early adopt these standards for financial reporting purposes, the institution should implement them in its Call Report for the same quarter-end report date.

accompanied by a leaseback and becomes the primary accounting guidance for sales of foreclosed real estate. Reference should also be made to the FFIEC 031 Consolidated Report of Condition and Income for a Bank with Domestic and Foreign Offices (Call Report), Schedules RC and M, and the instructions for the reporting of OREO transactions.

TRANSFER OF ASSETS TO OREO

Real estate assets transferred to OREO should be accounted for individually (on an asset-by-asset basis) on the date of transfer. Each transferred real estate asset should be recorded at its "fair value" less estimated cost to sell the asset. This "fair value" becomes the cost of the asset. "Fair value" is the amount the creditor should reasonably expect to receive for the asset in a current sale between a willing buyer and a willing seller (that is, not a forced liquidation sale).

The recorded amount of a loan (or an investment in a loan) at the time of foreclosure involving real estate transferred to OREO is the unpaid balance adjusted for any unamortized premium or discount and unamortized loan fees or costs, less any amount previously charged off, plus recorded accrued interest. Any excess of the recorded amount of the loan over the transferred property's fair value is a loss that must be charged against the allowance for loan and lease losses (ALLL) immediately upon the property's transfer to OREO. If the fair value (less costs to sell) of the property exceeds a recorded loan amount, the excess should be reported as a recovery of a previous charge-off or in current earnings, as appropriate. Legal fees and other direct costs incurred by the bank should generally be included in expenses.

The value of OREO properties must be reported at the fair value minus estimated selling expenses or the recorded loan amount. For example, if the recorded investment in the property is $125, the fair value of the property is $100, and the estimated selling expenses are $6, the carrying value for this property would be $94. The difference between the recorded loan amount of $125 and the fair value of $100 minus the $6 estimated cost to sell the property, or $31, would be charged to the ALLL at the time the property was transferred to OREO. Subsequent to the acquisition date, the OREO property should be reported at the lower of the cost of the property ($94 in this case) or the fair value of $100 less cost to sell of $6, which is also $94. Any subsequent declines in value should be recorded by creating a valuation allowance.

Alternatively, if the recorded loan amount is $250, the property's fair value is $275, and the estimated selling expenses are $18, the property's carrying value would be $257 (the property's fair value of $275 less estimated cost to sell of $18). The $7 difference between the fair value (less costs to sell) and the recorded loan amount would be recorded as a recovery of a previous charge-off or in current earnings, as appropriate. Before recording the $7 in earnings, significant scrutiny should be applied to understand why the borrower would risk losing the equity in the property. Additionally, in some states, lenders are required to return recovered amounts, in excess of the amount owed, to the borrower.

EVALUATIONS OF REAL ESTATE TO DETERMINE THE CARRYING VALUE OF OREO

The transfer of real estate pledged as collateral for a loan to OREO is considered to be a "transaction involving an existing extension of credit" under 12 CFR 225.63(a)(7) and is exempt from Regulation Y's appraisal requirement. However, under 12 CFR 225.63(b), the bank must obtain an "appropriate evaluation" of the real estate that is "consistent with safe and sound banking practices" to establish the carrying value of the OREO. A bank may elect, but is not required, to obtain an appraisal to serve as the "appropriate evaluation." Until the evaluation is available, a bank should rely on its best estimate of the property's value to establish the carrying value. The federal banking agencies have issued appraisal and evaluation guidelines to provide guidance to examining personnel and federally regulated institutions regarding prudent appraisal and evaluation policies, procedures, practices, and standards.

The appraisal or evaluation should provide an estimate of the parcel's market value. (Refer to section 4140.1, "Real Estate Appraisals and Evaluations," and its appendices A to D found in section A4140.1.) Generally, appraisals or evaluations contain an estimate of the property's fair value based on a forecast of expected cash flows, discounted at an interest rate that is commensurate with the risks involved. The cash flow estimate should include projected revenues and the costs of ownership, development, operation, marketing, and sale. In such situations, the appraiser or evaluator should fully describe the definition of value and the market conditions that have been considered in estimating the property's fair value.

PROPERTY ACQUIRED THROUGH FORECLOSURE—JUNIOR LIENHOLDER

When a bank acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the property should be recorded as an asset at its fair value less its estimated cost to sell. Any senior debt (principal and accrued interest) should be recorded as a corresponding liability. Senior debt should not be netted against the assets. Any excess of the recorded loan amount over the property's fair value less estimated cost to sell should be charged off to the ALLL. The recorded investment may not exceed the sum of any senior and junior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability. Interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

COLLATERAL-DEPENDENT LOANS

Collateral-dependent loans are those for which repayment is expected to be provided solely from the underlying collateral when there are no other available and reliable sources of repayment. Guidance for the treatment of certain troubled debts and collateral dependent loans is found in ASC 310-40, Receivables-Troubled Debt Restructurings by Creditors.[2] According to the instructions in the Call Report, collateral-dependent real estate loans (other than consumer mortgage loans) should be transferred to OREO when the lender has taken physical possession of the collateral, regardless of whether formal foreclosure proceedings have taken place. Otherwise, the bank should keep the collateral-dependent real estate loan categorized as a loan. To facilitate administration and tracking, however, banks may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Impairment of a collateral-dependent loan must be measured using the fair value of the collateral. In general, any portion of the recorded amount of a collateral-dependent loan in excess of the fair value of the collateral (less the estimated cost to sell) that can be identified as uncollectible should be promptly charged off against the ALLL. Examiners should review these loans using the same criteria applied to OREO.

For a residential real estate property collateralizing a consumer mortgage loan, a bank is considered to have received physical possession only upon the occurrence of either of the following:

(1) The bank obtains legal title to the residential real estate property upon completion of a foreclosure even if the borrower has redemption rights that provide the borrower with a legal right for a period of time after a foreclosure to reclaim the real estate property by paying certain amounts specified by law, or

(2) The borrower conveys all interest in the residential real estate property to the bank to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. The deed in lieu of foreclosure or similar legal agreement is completed when agreed-upon terms and conditions have been satisfied by both the borrower and the creditor.

PROPERTY ACQUIRED FOR FUTURE USE

Property the bank originally acquired for future use as premises, but for which plans have been abandoned, and property that formerly served as bank premises, should be accounted for at the lower of (1) its fair value less cost to sell or (2) the cost of the asset on the date of transfer to OREO. Any excess of book value over fair

2. See also SR letter 13-17, "Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings."

value should be charged to other operating expense during the current period.

CARRYING VALUE OF OREO

A bank should have a policy for periodically determining the fair value of its OREO property by obtaining an appraisal or an evaluation, as appropriate. While the Federal Reserve has no prescribed time frame for when a bank should reappraise or reevaluate its OREO property, the bank's policy should conform to state law, if applicable, and take into account the volatility of the local real estate market. A bank should determine whether there have been material changes to the underlying assumptions in the appraisal or valuation that have affected the original estimate of value. If material changes have occurred, the bank should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

ACCOUNTING FOR SUBSEQUENT CHANGES IN FAIR VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the ALLL. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized through the income statement by a charge to earnings. Banks should attempt to determine whether a property's decline in value is not recoverable, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for nonrecoverable losses in value is the direct write-down method, in which the charge to expenses is offset by a reduction in the OREO property's carrying value. If the reduction in value is deemed temporary, the charge to earnings may be offset by establishing a valuation allowance specifically for that property. In the event of subsequent appreciation in the value of an OREO property, the increase can only be reflected by reducing this valuation allowance or recognizing a gain upon disposition, but never by a direct write-up of the property's value. A change to the valuation allowance should be offset with a debit or credit to expense in the period in which it occurs.

In addition to the preceding treatment of the write-down in the OREO value, the previous subsection "Transfer of Assets to Other Real Estate Owned" discusses setting up a valuation allowance for estimated selling expenses associated with the sale of the other real estate. The balance of this valuation allowance can fluctuate based on changes in the fair value of the property held, but it can never be less than zero. The following examples are presented to illustrate the treatment that subsequent depreciation and appreciation would have on OREO properties.

Depreciation in an OREO Property's Value

Assume a bank has written down its initial recorded investment in an OREO property from \$125 to its fair value of \$100 minus costs to sell (assume costs to sell of \$6), or \$94. Assume that a new appraisal indicates a value of \$90, with reduced estimated selling expenses of \$5, or \$85. If the bank determines this decline in value is nonrecoverable, the bank must expense the depreciation of \$9 (\$94 minus \$85).

Appreciation in an OREO Property's Value

Assume a bank has written down its recorded investment in an OREO property to its fair value of \$110 less costs to sell of \$10, or \$100, and it subsequently created a valuation allowance for the \$10 temporary decline in value. A new appraisal indicates an increase in the value of the property to \$112 less costs to sell of \$9, or \$103. Notwithstanding the property's increased value, the recorded investment value cannot be increased above \$100. The valuation allowance for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment. In this case, the bank would reduce the valuation allowance to zero, which would increase the recorded value to \$100.

Accounting for OREO Income and Expense

Gross revenue from OREO should be recognized in the period in which it is earned. Direct costs incurred in connection with holding an OREO property, including legal fees, real estate taxes, depreciation, and direct write-downs, should be charged to expense when incurred.

A bank can expend funds to develop and improve OREO when it appears reasonable to expect that any shortfall between the property's fair value and the bank's recorded book value will be reduced by an amount equal to or greater than the expenditure. Such expenditures should not be used for speculation in real estate. The economic assumptions relating to the bank's decision to improve a particular OREO property should be well documented. Any payments for developing or improving OREO property are treated as capital expenditures and should be reflected by increasing the property's carrying value to the extent that those expenditures increase the value of the property.

DISPOSITION OF OREO

OREO property must be disposed of within any holding period established by state law and, in any case, as soon as it is prudent and reasonable. Banks should maintain documentation reflecting their efforts to dispose of OREO property, which should include

- a record of inquiries and offers made by potential buyers,
- methods used in advertising the property for sale whether by the bank or its agent, and
- other information reflecting sales efforts.

The sale or disposition of OREO property is considered a real estate-related financial transaction under the Board's appraisal regulation. A sale or disposition of an OREO property that qualifies as a federally related transaction under the regulation requires an appraisal conforming to the regulation. A sale or disposition that does not qualify as a federally related transaction nonetheless must comply with the regulation by having an appropriate evaluation of the real estate that is consistent with safe and sound banking practices.

The bank should promptly dispose of OREO if it can recover the amount of its original loan plus additional advances and other costs related to the loan or the OREO property before the end of the legal holding period. The holding period generally begins on the date that legal title to the property is transferred to the bank, except for real estate that has become OREO because the bank no longer contemplates using it as its premises. The holding period for this type of OREO property begins on the day that plans for future use are formally terminated. Some states require OREO property to be written off or depreciated on a scheduled basis, or to be written off at the end of a specified time period. The bank should determine whether such requirements exist and comply with them.

Financing Sales of OREO

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. Until the effective date of ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)," a gain resulting from a sale in which the bank provides financing should be accounted for under the standards described in ASC 360-20-40, Property, Plant and Equipment-Real Estate Sales-Derecognition. After the effective date of ASU 2014-09, a gain resulting from a sale in which the bank provides financing should be accounted for under the standards described in ASC Subtopic 610-20, Other Income–Gains and Losses from the Derecognition of Nonfinancial Assets. For further details, refer to the glossary section of the Call Report instructions under "foreclosed assets."

Nonrecourse Financing

Banks may promote the sale of foreclosed real estate by offering nonrecourse financing to buyers. These loans should be made under the same credit terms and underwriting standards the bank employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

RENTAL OF RESIDENTIAL OREO PROPERTIES

OREO Rental Policy Statement Overview

The Federal Reserve issued a policy statement[3] on April 5, 2012, indicating that, consistent with

3. See SR letter 12-5/CA letter 12-3, "Policy Statement on Rental of Residential Other Real Estate Owned (OREO) Properties," and its attachment.

the general policy of the Federal Reserve and in light of the extraordinary market conditions that existed, banking organizations may rent one- to four-family residential OREO properties without having to demonstrate continuous active marketing of the properties, provided suitable policies and procedures are followed.[4] Under these conditions and circumstances, banking organizations would not contravene supervisory expectations that they show "good-faith efforts" to dispose of OREO by renting the property within the applicable holding period. Key risk-management considerations for banking organizations that engage in the rental of residential OREO, including compliance with holding-period requirements for OREO, compliance with landlord-tenant and associated requirements, and accounting according to generally accepted accounting principles (GAAP). Rental of OREO properties with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return should generally not be classified.

The statement establishes specific supervisory expectations for banking organizations that undertake large-scale residential OREO rentals (generally, 50 properties or more available for rent). Such organizations should have formal policies and procedures governing the operation and administration of OREO rental activities, including property-specific rental plans, policies and procedures for compliance with applicable laws and regulations, a risk-management framework, and oversight of third-party property managers.

Policy Statement on Rental of Residential OREO Properties

In light of the large volume of distressed residential properties and the indications of higher demand for rental housing in many markets, some banking organizations may choose to make greater use of rental activities in their disposition strategies than in the past. In response to the volume of these activities, the Federal Reserve adopted an April 2012 policy statement, whereby banking organizations may rent one- to four-family residential OREO properties without having to demonstrate continuous active marketing of such properties, provided suitable policies and procedures are followed. This policy statement reminds banking organizations and examiners that the Federal Reserve's regulations and policies permit the rental of residential OREO properties to third-party tenants as part of an orderly disposition strategy within statutory and regulatory limits.[5] This policy statement applies to state member banks, BHCs, nonbank subsidiaries of BHCs, savings and loan holding companies, non-thrift subsidiaries of savings and loan holding companies, and U.S. branches and agencies of foreign banking organizations (collectively, banking organizations).

The general policy of the Federal Reserve is that banking organizations should make good-faith efforts to dispose of OREO properties at the earliest practicable date. Consistent with this policy, in light of the extraordinary market conditions that currently prevail, banking organizations may rent residential OREO properties (within statutory and regulatory holding-period limits) without having to demonstrate continuous active marketing of the property, provided that suitable policies and procedures are followed. Under these conditions and circumstances, banking organizations would not contravene supervisory expectations that they show "good-faith efforts" to dispose of OREO by renting the property within the applicable holding period. Moreover, to the extent that OREO rental properties meet the definition of community development under the Community Reinvestment Act (CRA) regulations, they would receive favorable CRA consideration.[6] In all respects, banking organizations that rent OREO properties are expected to comply with all applicable federal, state, and local statutes and regulations.

Home prices have been under considerable downward pressure since the financial crisis began, in part due to the large volume of houses for sale by creditors, whether acquired through foreclosure or voluntary surrender of the property by a seriously delinquent borrower (distressed sales). Creditors, in turn, often seek to

4. The policy statement supplements other relevant Federal Reserve guidance, including the Board's policy statement on the disposition of property acquired in satisfaction of debts previously contracted. See 12 CFR 225.140.

5. The term "residential properties" in this policy statement encompasses all one- to four-family properties and does not include multifamily residential or commercial properties.

6. The Federal Reserve's CRA regulations define community development to include activities that provide affordable housing for low- and moderate-income individuals as well as those activities that revitalize or stabilize low- and moderate-income areas (see 12 CFR 228.12(g)(1) and (4)).

liquidate their inventories of such properties quickly. Since 2008, it is estimated that millions of residential properties have passed through lender inventories. These distressed sales represent a significant proportion of all home sales transactions, despite some ebb and flow, and thus are a contributing element to the downward pressure on home prices. With mortgage delinquency rates remaining stubbornly high, the continued inflow of new real estate owned properties to the market—expected to be millions more over the coming years—will continue to weigh on house prices for some time.[7]

Banking organizations include their holdings of such properties in OREO on regulatory reports and other financial statements.[8] Existing federal and state laws and regulations limit the amount of time banking organizations may hold OREO property.[9] In addition, there are established supervisory expectations for management of OREO properties and the nature of the efforts banking organizations should make to dispose of these properties during that period.

Risk-Management Considerations for Residential OREO Property Rentals

In all circumstances, the Federal Reserve expects a banking organization considering such rentals to evaluate the overall costs, benefits, and risks of renting. The banking organization's decision to rent OREO might depend significantly on the condition of individual properties, local market conditions for rental and owner-occupied housing, and its capacity to engage in rental activity in a safe and sound manner and consistent with applicable laws and regulations.

Banking organizations should have an operational framework for their residential OREO rental activities that is appropriate to the extent to which they rent OREO properties. In general, banking organizations with relatively small holdings of residential OREO properties—fewer than 50 individual properties rented or available for rent—should use a framework that appropriately records the organizations' rental decisions and transactions as they take place, preserves key documents, and is otherwise sufficient to safeguard and manage the individual OREO assets.[10] In contrast, banking organizations with large inventories of residential OREO properties[11]—50 or more individual properties available for rent or rented—should utilize a framework that systematically documents how they meet the supervisory expectations described in the next section. All banking organizations that rent OREO properties, irrespective of the size of their holdings, should adhere to the guidance set forth in this section.

Compliance with Maximum OREO Holding-Period Requirements

Banking organizations should pursue a clear and credible approach for ultimate sale of the rental OREO property within the applicable holding-period limitations. Exit strategies in some cases may include special transaction features to facilitate the sale of OREO, potentially including prudent use of seller-assisted financing or rent-to-own arrangements with tenants.

Compliance with Landlord-Tenant and Other Associated Requirements

Banking organizations' residential property rental activities are expected to comply with all applicable federal, state, and local laws and regulations, including landlord-tenant laws; landlord licensing or registration requirements; property maintenance standards; eviction protec-

7. For further discussion of housing market conditions and the obstacles to conversions of OREO properties to rental, see "The U.S. Housing Market: Current Conditions and Policy Considerations," Federal Reserve staff white paper, January 4, 2012 (housing white paper).

8. "Other real estate owned" is comprised of all real estate other than (1) bank premises owned or controlled by the bank and its consolidated subsidiaries and (2) direct and indirect investments in real estate ventures.

9. Generally, the Federal Reserve allows BHCs to hold OREO property for up to five years, with an additional five-year extension subject to certain circumstances (see 12 CFR 225.140). National banks are subject to similar restrictions. State member banks and licensed branches of foreign banks are subject to the holding periods and other limitations on OREO activity established by their respective licensing authorities, which vary. Savings and loan holding companies generally may acquire real estate for rental (see 12 USC 1467a(c)(2) and 12 CFR 238.53(b)).

10. A preliminary analysis of December 2011 Call Report data suggests that roughly 98 percent of community banks held 50 or fewer residential OREO properties.

11. For purposes of this guidance, the supervisory expectations for OREO rentals and the number of properties available for rent should include those properties for which tenants were already in place at the time of foreclosure or transfer of ownership. See the *Federal Reserve Consumer Compliance Handbook*, Section IV for further information.

tions; protections under the Servicemembers Civil Relief Act;[12] and anti-discrimination laws, including the applicable provisions of the Fair Housing Act and the Americans with Disabilities Act. Prior to undertaking the rental of OREO properties, banking organizations should determine whether such activities are legally permissible under applicable laws, including state laws. When applicable, banking organizations should review homeowner and condominium association bylaws and local zoning laws for prohibitions on renting a property. Banking organizations may use third-party vendors to manage properties but should provide necessary oversight to ensure that property managers fully understand and comply with these federal, state, and local requirements.

Other Considerations

Banking organizations should account for OREO assets in accordance with GAAP and applicable regulatory reporting instructions.[13]

Specific Expectations for Large-Scale Residential OREO Rentals

Banking organizations with large inventories of residential OREO properties that decide to engage in rental activities should have in place a documented rental strategy, including formal policies and procedures for OREO rental activities and a documented operational framework. Policies and procedures should clearly describe how the banking organization will comply with all applicable laws and regulations. Policies and procedures should include processes for determining whether the properties meet local building code requirements and are otherwise habitable, and whether improvements to the properties are needed in order to market them for rent. In addition, policies and procedures should establish operational standards for the banking organization's rental activities, including that adequate insurance policies are in place, that property and other tax obligations are met on a timely basis, and that expenditures on improvements are appropriate to the value of the property and to prevailing norms in the local market.

Policies and procedures should also require plans for rental of residential OREO properties, down to the individual property level, that cover the full holding period from the time the bank received title to ultimate sale by the bank. Plans should identify which properties would be eligible for rental. Plans also should establish criteria by which properties are chosen for marketing as rental properties, and the process by which rental decisions should be made and implemented. Plans should describe the general conditions under which the organization believes a rental approach is likely to be successful, including appropriate consideration of rental market and economic conditions in respective local markets.

Finally, policies and procedures should address all risk-management issues that arise in renting residential OREO properties. Some risk elements parallel those found in other banking activities, for example, the credit risk associated with tenants' potential failure to make timely rent payments, or potential conflict of interest issues such as the use of a firm by a banking organization to both provide information on a property's value and list that property for sale on behalf of the banking organization. Other risks unique to such rental include

- dealing with vacancy, marketing, and re-rental of previously occupied properties;[14]
- liability risk arising from rental activities, along with the use and management of liability insurance or other approaches to mitigate that liability and risk; and
- legal requirements arising from the potential need to take action against tenants for rent delinquency, potentially including eviction. Such requirements may include notice periods.

Banking organizations may need to develop new policies and risk-management processes to address properly these categories of risk.

In many cases, banking organizations will use third-party vendors (for example, real estate agents or professional property managers) to manage their OREO properties. Policies and procedures should provide that such individuals or organizations have appropriate expertise in

12. See CA letter 05-3, "Servicemembers Civil Relief Act of 2003," May 6, 2005.

13. See the instructions for the Consolidated Reports of Condition and Income (Call Report) as to the reporting of OREO transactions and to the Consolidated Financial Statements for Holding Companies (FR Y-9C).

14. Various jurisdictions may apply specific requirements to landlords in their marketing and re-rental activities (for example, an obligation to offer potential tenants an initial lease term of two years).

property management, be in sound financial condition, and have a good track record in managing similar properties. Policies and procedures should also call for contracts with such vendors to carry appropriate terms and provide, among other key elements, for adequate management information systems and reporting to the banking organization, including rent rolls (along with actual lease agreements), maintenance logs, and security deposits and charges to these deposits. Banking organizations should provide for adequate oversight of vendors.

Additional Materials for Reference

- ASC 310-40, Receivables-Troubled Debt Restructurings by Creditors (formerly known as FAS 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings").
- ASC 360-10-30, Property, Plant and Equipment-Initial Measurement (formerly included in FAS 144, "Accounting for the Impairment or Disposal of Long-Lived Assets").
- ASC 360-10-35, Property, Plant and Equipment-Subsequent Measurement.
- Until ASU 2014-09 is effective, ASC Subtopic 360-20, Property, Plant, and Equipment —Real Estate Sales is the primary accounting guidance for sales of foreclosed real estate.
- Once ASU 2014-09 is effective, ASC Subtopic 610-20 is the primary accounting guidance for sales of foreclosed real estate.
- SR letter 13-19/CA letter 13-21, "Guidance on Managing Outsourcing Risk," December 5, 2013.
- SR letter 10-16, "Interagency Appraisal and Evaluation Guidelines," December 2, 2010, and this manual's section 4140.1. For the sale of OREO property with a value of $250,000 or less, a BHC or state member bank may obtain an evaluation in lieu of an appraisal.
- SR letter 95-16, "Real Estate Appraisal Requirements for Other Real Estate Owned (OREO)," March 28, 1995.
- SR letter 12-10/CA letter 12-9, "Questions and Answers for Federal Reserve-Regulated Institutions Related to the Management of Other Real Estate Owned (OREO)," June 28, 2012.

CLASSIFICATION OF OREO

The examiner should generally evaluate the adequacy of the bank's information to support the carrying value of an OREO property, and the appropriateness of its classification. OREO usually should be considered a problem asset, even when it is carried at or below its fair value. Despite the apparent adequacy of the property's fair value, the bank's acquisition of OREO through foreclosure usually indicates a lack of demand for the property or weaknesses in the property's condition.

When evaluating the OREO property for classification purposes, the examiner must consider the property's fair value, whether it is being held in conformance with state law, and whether it is being disposed of according to the bank's plan. The amount of an OREO property subject to classification is the carrying value of the property, net of any specific valuation allowance. The existence of a specific valuation allowance does not preclude adverse classification of OREO. Banking organizations should also provide the appropriate classification treatment for their residential OREO holdings. Residential OREO is typically treated as a substandard asset, as defined by the interagency classification guidelines (see section 2060.1, "Classification of Credits"). However, residential properties with leases in place and demonstrated cash flow from rental operations sufficient to generate a reasonable rate of return[15] should generally not be classified. The

15. Whether a rate of return is reasonable depends on a number of considerations, including local market conditions, the time horizon of the rental, and the nature of the property. Commonly used measures include a capitalization rate (known as a "cap rate," which generally is the expected annual cash flows from renting the property relative to the price at which the property holder could expect to sell it in the owner-occupied market), as discussed in the housing white paper, or other measures of internal rate of return. Depending on the circumstances and risks associated with the property, valid indications that a level of return is reasonable could include (but would not be not limited to) comparisons with normal returns for single-family rentals in the relevant local market; rates of return on other similar local real estate investments; or cap rates or other measures of internal rate of return on investments with similar risk profiles. For example, in many markets a cap rate above 8 percent would likely represent a reasonable rate of return. Large one-time expenditures that are idiosyncratic to a given year but are normal to residential properties over their lifetime, such as replacement costs for worn-out appliances, should generally not be the reason that a property would be classified. Costs of improvement should be treated as capital expenditures with a corresponding effect on the properties' carrying values, but only to the extent the

examiner should review all types of OREO for classification purposes. When the bank provides financing, the examiner should determine whether the loan is prudently underwritten.

The examiner should review all relevant factors to determine the quality and risk of the OREO property and the degree of probability that its carrying value will be realized. Some factors the examiner should consider include

- the property's carrying value relative to its fair value (including the date of any appraisal or evaluation relative to changes in market conditions), the bank's asking price, and offers received;
- the source and quality of the appraisal or evaluation, including the reasonableness of assumptions, such as projected cash flow for commercial properties;
- the length of time a property has been on the market and local market conditions for the type of property involved, such as history and trend of recent sales for comparable properties;
- bank management's ability and track record in liquidating other real estate and assets acquired in satisfaction of debts previously contracted;
- income and expenses generated by the property and other economic factors affecting the probability of loss exposure;
- the manner in which the bank intends to dispose of the property;
- other pertinent factors, including property-title problems, statutory redemption privileges, pending changes in the property's zoning, environmental hazards, other liens, tax status, and insurance.

improvements increase the properties' values.

ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a bank may be liable for cleaning up hazardous substance contamination of OREO. In some cases, the liability may arise before the bank takes title to a borrower's real estate collateral. A property's transition from collateral to bank ownership may take an extended period of time. As the financial problems facing a borrower worsen, a bank may become more involved in managing a company or property. Such involvement may become extensive enough that the bank is deemed to have met substantially all ownership criteria, the absence of a clear title in the bank's name notwithstanding. Generally, the more bank management is involved in such activity, the greater the bank's exposure to any future clean-up costs assessed in connection with the property. A more thorough discussion of environmental liability can be found in section 2040.1, "Loan Portfolio Management," of this manual, under the subsection "Other Lending Concerns."

1. To determine if the policies, practices, procedures, and internal controls regarding other real estate owned are adequate.
2. To determine that bank officers and employees are operating in conformance with the established guidelines.
3. To evaluate the validity and quality of all other real estate owned.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with laws and regulations.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. If selected for implementation, complete the Other Real Estate Owned section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures and obtain a listing of any audit deficiencies noted in the latest review done by internal/external auditors and determine if appropriate corrections have been made.
3. Obtain a list of other real estate owned and agree total to general ledger.
4. Review the other real estate owned account to determine if any property has been disposed of since the prior examination and:
   a. If so, determine that:
      - The bank accepted written bids for the property.
      - The bids are maintained on file.
      - There is justification for accepting a lower bid if the bank did not accept the highest one.
   b. Investigate any insider transactions.
5. Test compliance with applicable laws and regulations:
   a. Determine that other real estate owned is held in accordance with the provisions of applicable state law.
   b. Determine if other real estate is being amortized or written off in compliance with applicable state law.
   c. Consult with the examiners assigned to ‘‘Loan Portfolio Management,’’ ‘‘Other Assets and Other Liabilities,’’ ‘‘Reserve for Possible Loan Losses’’ and ‘‘Bank Premises and Equipment’’ to determine if the situation holds real estate acquired as salvage on uncollectible loans, abandoned bank premises or property originally purchased for future expansion, which is no longer intended for such usage.
   d. Review the details of all other real estate owned transactions to determine that:
      - The property has been booked at its fair value.
      - The documentation reflects the bank’s persistent and diligent effort to dispose of the property.
      - If the bank has made expenditures to improve and develop other real estate owned, proper documentation is in the file.
      - Real estate that is former banking premises has been accounted for as other real estate owned since the date of abandonment.
      - Such property is disposed of in accordance with state law.
6. Review parcels of other real estate owned with appropriate management personnel and, if justified, assign appropriate classification. Classification comments should include:
   a. Description of property.
   b. How real estate was acquired.
   c. Amount and date of appraisal.
   d. Amount of any offers and bank’s asking price.
   e. Other circumstances pertinent to the classification.
7. Review the following with appropriate management personnel or prepare a memo to other examiners for their use in reviewing with management:
   a. Internal control exceptions and deficiencies in, or non-compliance with, written policies, practices and procedures.
   b. Uncorrected audit deficiencies.
   c. Violations of law.
8. Prepare comments in appropriate report form for all:
   a. Criticized other real estate owned.
   b. Deficiencies noted.
   c. Violations of law.
9. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for other real estate owned. The bank's systems 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.

RECORDS

1. Is the preparation, addition, and posting of subsidiary other real estate owned records performed and/or tested by persons who do not have direct, physical or accounting, control of those assets?
2. Are the subsidiary other real estate owned records balanced at least annually to the appropriate general ledger accounts by persons who do not have direct, physical or accounting, control of those assets?
3. Is the posting to the general ledger other real estate owned accounts approved, prior to posting, by persons who do not have direct, physical or accounting, control of those assets?
4. Are supporting documents maintained for all entries to other real estate owned accounts?
5. Are acquisitions and disposals of other real estate owned reported to the board of directors or its designated committee?
6. Does the bank maintain insurance coverage on other real estate owned including liability coverage where necessary?
7. Are all parcels of other real estate owned reviewed at least annually for:
   a. Current appraisal or certification?
   b. Documentation inquiries and offers?
   c. Documented sales efforts?
   d. Evidence of the prudence of additional advances?

OTHER PROCEDURES

8. Are the bank's policies and procedures relating to the real estate owned in writing?

CONCLUSION

9. 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.
10. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

This section provides guidance on the management of a depository institution's investment and end-user activities. The guidance applies to (1) all securities in held-to-maturity and available-for-sale accounts,[1] (2) all certificates of deposit held for investment purposes, and (3) all derivative contracts not held in trading accounts (end-user derivative contracts).[2] The section discusses securities used for investment purposes, including money market instruments, fixed- and floating-rate notes and bonds, structured notes, mortgage pass-through and other asset-backed securities (ABS), and mortgage-derivative products.

National banks (in accordance with 12 CFR 1) and state member banks are to make assessments of a security's creditworthiness to determine whether it's investment-grade.[3] The section emphasizes bank-eligible investments—securities that meet an "investment grade" test—whereby the issuer of a security has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure. An 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. A bank is expected to assess credit risk in an investment security based on the bank's risk profile and for the size and complexity of the instrument.[4] Generally, investment securities are expected to have good to very strong credit quality. In the case of structured securities, this determination may be influenced more by the quality of the underlying collateral, the expected cash flows, and the structure of the security itself than by the condition of the issuer. While banks are no longer able to rely solely on external ratings, they can be used to support the credit risk due diligence processes of the bank. Banks are expected to conduct an appropriate level of due diligence to understand the inherent risks of a security and determine that it is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the "investment-grade" standards. The depth of the due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment. Third-party analytics may be part of this analysis. The bank's management, however, remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. The board of directors should oversee management to make sure that appropriate decisionmaking processes are in place.[5]

Investments in securities and stock by state member banks are required under the Federal Reserve Act and Regulation H to comply with 12 CFR 1. They also should meet the supervisory expectations set forth in the OCC's investment guidance, "OCC Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment" (see section 2022.1), and the guidance set forth in SR-12-15. In addition, state member banks are expected to continue to meet long-established supervisory expectations for risk-management processes to ensure that the credit risk of the bank, including the credit risk of the investment portfolio, is effectively identified, measured, monitored, and controlled. Investments by state member banks must also comply with applicable state law.

Many of these expectations are set forth in the 1998 interagency "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities." See SR-98-12 ("FFIEC Policy Statement on Investment Securities and End-User Derivatives Activities"), which provides risk-management standards for the securities investment activities of banks and savings associations. SR-98-12 and the policy statement emphasize the importance of an institution conducting a thorough credit-risk analysis before and periodically after the acquisition of a security. Such analysis allows an institution to understand and effectively manage the risks within its investment portfolio, including credit risk, and is an essential element of a sound investment

1. Refer to Statement of FASB Accounting Standards Codification Section 320-10-35, Investments-Debt and Equity Securities-Subsequent Measurement (formerly FAS 115, "Accounting for Certain Investments in Debt and Equity Securities").

2. Derivatives, in general, are financial contracts whose values are derived from the value of one or more underlying assets, interest rates, exchange rates, commodities, or financial or commodity indexes.

3. For the OCC's final rules, see 77 *Fed. Reg.* 35253 (June 13, 2012); for its guidance, see 77 *Fed. Reg.* 35259 (June 13, 2012) and OCC Bulletin 2012-18 (June 26, 2012).

4. See 77 *Fed. Reg.* 35254 (June 13, 2012).

5. See 77 *Fed. Reg.* 35259 (June 13, 2012).

portfolio risk-management framework. These supervisory expectations include criteria that institutions can use in meeting the requirements within 12 CFR 1. State member banks should follow these expectations when deciding whether to invest in securities.

An institution's maintenance of timely information about market risk-measurement systems is discussed within this section, including the information on the current carrying values of its securities and derivative holdings. This includes an institution's use of internal models and its need to validate the models. (See SR-11-7.) Swaps, futures, and options and other end-user derivative instruments used for non-trading purposes are discussed.

Institutions must ensure that their investment and end-user activities are permissible and appropriate within established limitations and restrictions on bank holdings of these instruments. Institutions should also employ sound risk-management practices consistently across these varying product categories, regardless of their legal characteristics or nomenclature. This section provides examiners with guidance on—

- the permissibility and appropriateness of securities holdings by state member banks;
- sound risk-management practices and internal controls used by banking institutions in their investment and end-user activities;
- the review of securities and derivatives acquired by the bank's international division and overseas branches for its own account as well as the bank's foreign equity investments that are held either directly or through Edge Act corporations;
- banking agency policies on certain high-risk mortgage-derivative products; and
- unsuitable investment practices.

LIMITATIONS AND RESTRICTIONS ON SECURITIES HOLDINGS

Many states extend the investment authority that is available to national banks to their chartered banks—often by direct reference. The security investments of national banks are governed in turn by the seventh paragraph of 12 USC 24 (12 USC 24 (Seventh)) and by the investment securities regulations of the Office of the Comptroller of the Currency (OCC), 12 CFR 1. These standards also apply to federal branches of foreign banks. If state law permits, pursuant to 12 USC 335, state member banks are subject to the same limitations and conditions for purchasing, selling, dealing in, and underwriting investment securities and stocks as national banks under 12 USC 24 (Seventh).[6] To determine whether an obligation qualifies as a permissible investment for state member banks, and to calculate the limits with respect to the purchase of such obligations, refer to the OCC's investment securities regulation at 12 CFR 1. (See also section 2022.1, "OCC Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment," and section 208.21(b) of Regulation H (12 CFR 208.21(b)).)

Under 12 USC 24, "investment securities" are defined as "marketable obligations, evidencing indebtedness . . . in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the 'investment securities' as may be by regulation prescribed by the Comptroller of the Currency." Nothing contained in this provision of the statute authorizes the purchase by the association (national bank) for its own account of any shares of stock of any corporation. The OCC's investment securities regulation (at 12 CFR 1) defines *investment security* as a marketable debt obligation that is investment grade and not predominately speculative in nature. *Investment grade* means the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset or exposure. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected.

Marketable means that the security—

- is registered under the Securities Act of 1933, 15 USC 77a et seq.;
- is a municipal revenue bond exempt from registration under the Securities Act of 1933, 15 USC 77c(a)(2);
- is offered and sold pursuant to Securities and Exchange Commission Rule 144A, 17 CFR 230.144A, and investment grade; or

6. References to a "bank" in this section mean a state member bank and a national bank, unless stated otherwise.

• can be sold with reasonable promptness at a price that corresponds reasonably to its fair value.

Bank-Eligible Securities

The OCC's investment securities regulation, 12 CFR 1.2, identifies five basic types of investment securities (Types I, II, III, IV, and V) and establishes limitations on a bank's investment in those types of securities based on the percentage of capital and surplus that such holdings represent. For calculating concentration limits, the term "capital and surplus" includes a bank's tier 1 and tier 2 capital and the balance of a bank's allowance for loan and lease losses not included in tier 2 capital. Table 2 summarizes bank-eligible securities and their investment limitations.

Table 2—Summary of Investment-Type Categories

Type Category	*Characteristics*	*Limitations*
Type I securities	• U.S. government obligations and obligations issued, insured, or guaranteed by a U.S. department or agency, if backed by the full faith and credit of the U.S. government • general obligations of a state of the U.S. or any political subdivision thereof • municipal bonds, if the bank is well capitalized,* other than Types II, III, IV, or V securities	The bank may deal in, underwrite, purchase, and sell Type I securities for its own account. The amount of Type I securities that the bank may deal in, underwrite, purchase, and sell is not limited to a specified percentage of the bank's capital and surplus. With respect to all municipal securities, a member bank that is well capitalized* may deal in, underwrite, purchase, and sell any municipal bond for its own account without any limit tied to the bank's capital and surplus.

continued

* subject to the statutory prompt-corrective-action standards (12 USC 1831o)

Type Category	*Characteristics*	*Limitations*
Type II securities	• obligations issued by a state, or a political subdivision or agency of a state for housing, university, or dormitory purposes that would not qualify as a Type I municipal security • obligations of international and multilateral development banks • other obligations that a national bank is authorized to deal in, underwrite, purchase, and sell for the bank's own account as listed in 12 USC 24 (Seventh), other than Type I securities • other securities the OCC determines to be eligible as Type II securities	The bank may deal in, underwrite, purchase, and sell Type II securities for its own account, provided the aggregate par value of Type II securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. When applying this limitation, the bank is to take account of Type II securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings. The bank may not hold Type II securities issued by any one obligor with an aggregate par value exceeding 10 percent of the bank's capital and surplus. However, if the proceeds of each issue are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and if each issue is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases, the bank may apply the 10 percent investment limitation separately to each issue of a single obligor. continued

Type Category	*Characteristics*	*Limitations*
Type III securities	• an investment security that does not qualify as Type I, II, IV, or V security; examples of Type III securities include— — corporate bonds, and — municipal bonds that do not satisfy the definition of Type I securities in 12 CFR 1.2 (j) or the definition of Type II securities in 12 CFR 1.2 (k)	The bank may purchase and sell Type III securities for its own account, provided the aggregate par value of Type III securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type III securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings. The bank may not hold Type III securities issued by any one obligor with an aggregate par value exceeding 10 percent of the bank's capital and surplus. However, if the proceeds of each issue are to be used to acquire and lease real estate and related facilities to economically and legally separate industrial tenants, and if each issue is payable solely from and secured by a first lien on the revenues to be derived from rentals paid by the lessee under net noncancellable leases, the bank may apply the 10 percent investment limitation separately to each issue of a single obligor. continued

Type Category	*Characteristics*	*Limitations*
Type IV securities	• a small business-related security as defined in section 3(a)(53)(A) of the Securities Exchange Act of 1934, 15 USC 78c(a)(53)(A), that is fully secured by interests in a pool of loans to numerous obligors • commercial mortgage-related security that is offered or sold pursuant to section 4(5) of the Securities Act of 1933, 15 USC 77d(5), that is investment grade, or a commercial mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934 that represents ownership of a promissory note or certificate of interest or participation that is directly secured by a first lien on one or more parcels of real estate upon which one or more commercial structures are located and that is fully secured by interests in a pool of loans to numerous obligors • a residential mortgage-related security that is offered and sold pursuant to section 4(5) of the Securities Act of 1933, 15 USC 77d(5), that is investment grade, or a residential mortgage-related security as described in section 3(a)(41) of the Securities Exchange Act of 1934, 15 USC 78c(a)(41)) that does not otherwise qualify as a Type I security	The bank may purchase and sell Type IV securities for its own account. The amount of the Type IV securities that a bank may purchase and sell is not limited to a specified percentage of the bank's capital and surplus.
Type V securities	• a security that is— — investment grade; — marketable; — not a Type IV security; and — fully secured by interests in a pool of loans to numerous obligors and in which a national bank could invest directly	The bank may purchase and sell Type V securities for its own account provided that the aggregate par value of Type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus. In applying this limitation, a national bank shall take account of Type V securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

Type I securities are those debt instruments that national and state member banks can deal in, underwrite, purchase, and sell for their own accounts without limitation. Type I securities are obligations of the U.S. government or its agencies; general obligations of states and political subdivisions; municipal bonds (including municipal revenue bonds) other than a Type II, III, IV, or V security by a bank that is well capitalized; and mortgage-related securities. A bank may purchase Type I securities for its own account subject to no limitations, other than the exercise of prudent banking judgment. (See 12 USC 24 (Seventh) and 15 USC 78(c)(a).)

Type II securities are those debt instruments that national and state member banks may deal in, underwrite, purchase, and sell for their own account subject to a 10 percent limitation of a bank's capital and surplus for any one obligor. Type II investments include obligations issued by the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the Tennessee Valley Authority, and the U.S. Postal Service, as well as obligations issued by any state or political subdivision for housing, university, or dormitory purposes that do not qualify as a Type I security and other issuers specifically identified in 12 USC 24 (Seventh).

Type III securities is a residual securities category consisting of all types of investment securities not specifically designated to another security "type" category and that do not qualify as a Type I security. The bank may purchase and sell Type III securities for its own account, provided the aggregate par value of Type III securities issued by any one obligor held by the bank does not exceed 10 percent of the bank's capital and surplus for any one obligor. In applying this limitation, the bank must take account of Type III securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

Type IV securities. A bank may purchase and sell Type IV securities for its own account. The amount of securities that a bank may purchase and sell is not limited to a specified percentage of the bank's capital and surplus. Type IV securities include the following ABS that are fully secured by interests in pools of loans made to numerous obligors:

- investment-grade residential mortgage-related securities that are offered or sold pursuant to section 4(5) of the Securities Act of 1933 (15 USC 77d(5))
- residential mortgage-related securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) that are rated in one of the two highest investment-grade rating categories
- investment-grade commercial mortgage securities offered or sold pursuant to section 4(5) of the Securities Act of 1933 (15 USC 77d(5))
- commercial mortgage securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) that are rated in one of the two highest investment-grade rating categories
- investment-grade, small-business-loan securities as described in section 3(a)(53)(A) of the Securities Exchange Act of 1934 (15 USC 78c(a)(53)(A))

For all Type IV commercial and residential mortgage securities and for Type IV small-business-loan securities, there is no limitation on the amount a bank can purchase or sell for its own account. In addition to being able to purchase and sell Type IV securities, subject to the above limitation, a bank may deal in those Type IV securities that are fully secured by Type I securities.

Type V securities consist of all ABS that are not Type IV securities. Specifically, they are defined as marketable, investment-grade securities that are not Type IV and are "fully secured by interests in a pool of loans to numerous obligors and in which a bank could invest directly." Type V securities include securities backed by auto loans, credit card loans, home equity loans, and other assets. Also included are residential and commercial mortgage securities as described in section 3(a)(41) of the Securities Exchange Act of 1934 (15 USC 78c(a)(41)) that are investment grade. A bank may purchase or sell Type V securities for its own account provided the aggregate par value of Type V securities issued by any one issuer held by the bank does not exceed 25 percent of the bank's capital and surplus. In applying this limitation, the bank must take account of Type V securities that the bank is legally committed to purchase or to sell in addition to the bank's existing holdings.

Additional Limitations

Securities Held Based on Estimates of Obligor's Performance

Notwithstanding the definition of "investment security" and "investment grade," a bank may treat a debt security as an investment security under the rule if it does not meet those definitions, provided that the security is marketable and the bank concludes, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security. However, the aggregate value of such securities based on "reliable estimate" may not exceed 5 percent of the bank's capital and surplus. This activity must conform with the safety-and-soundness practices required by 12 CFR 1.5 (discussed below).

As shown in Table 2, there are *separate* Type I, II, III, IV, and V limits. In the extreme, however, banks can lend 15 percent of their capital to a corporate borrower, buy the borrower's corporate bonds amounting to another 10 percent of capital and surplus (Type III securities), and purchase the borrower's ABS up to an additional 25 percent of capital (Type V securities), for a total exposure of 50 percent of the bank's capital and surplus. This could be expanded even further if the borrower also issued highly rated Type IV securities, upon which there is no investment limitation. However, an exposure to any one issuer of 25 percent or more should be considered a credit concentration, and banks are expected to justify why exposures in excess of 25 percent do not entail an undue concentration.

Pooled Investments

A bank may purchase and sell for its own account investment company shares provided that—

a. the portfolio of the investment company consists exclusively of assets that the bank may purchase and sell for its own account, and
b. the bank's holdings of investment company shares do not exceed the limitations in 12 CFR 1.4(e).

Other Issues

The OCC may determine that a national bank may invest in an entity that is exempt from registration as an investment company under section 3(c)(1) of the Investment Company Act of 1940, provided that the portfolio of the entity consists exclusively of assets that a national bank may purchase and sell for its own account and that investments made under this authority comply with safe-and-sound practices under section 1.5 of the rule and applicable published OCC precedent. These investments also must be—

a. marketable and investment grade, or
b. satisfy the requirements of 12 CFR 1.3(i) (securities held based on estimates of obligor's performance). A bank may treat a debt security as an investment security if the security is marketable and the bank can conclude, on the basis of estimates that the bank reasonably believes are reliable, that the obligor will be able to satisfy its obligations under that security.

Safe-and-Sound Banking Practices

As set forth in section 1.5, a bank shall adhere to safe-and-sound banking practices and the specific requirements of this part when conducting the investment activities permitted under the rule. As stated in section 1.5, the bank is to consider, as appropriate, the interest rate, credit, liquidity, price, foreign exchange, transaction, compliance, strategic, and reputation risks presented by a proposed activity, and the particular activities undertaken by the bank, which must be appropriate for that bank.

When conducting these activities, the bank shall determine that there is adequate evidence that an obligor possesses resources sufficient to provide for all required payments on its obligations, or, in the case of securities deemed to be investment securities on the basis of reliable estimates of an obligor's performance, that the bank reasonably believes that the obligor will be able to satisfy the obligation.

The bank must maintain records that are available for examination purposes and are adequate to demonstrate that it meets the requirements of this part (12 CFR 1). The bank may store the information in any manner that can be readily retrieved and reproduced in a readable form.

Reservation of Authority

In addition to the investment securities discussed in 12 USC 24 (Seventh), the OCC may determine, on a case-by-case basis, that a national bank may acquire an investment security other than an investment security of a type set forth in this part, provided the OCC determines that the bank's investment is consistent with 12 USC 24 (Seventh) and with safe-and-sound banking practices. (See 73 *Fed. Reg.* 22235, April 24, 2008, and 12 CFR 1.1 for more information.) A state member bank should consult the Board for a determination with respect to the application of 12 USC 24 (Seventh), with respect to issues not addressed in 12 CFR 1. The provisions of 12 CFR 1 do not provide authority for a state member bank to purchase securities of a type or amount that the bank is not authorized to purchase under applicable state law. (See 12 CFR 208.21(b).)

Municipal Revenue Bonds

Upon enactment of the Gramm-Leach-Bliley Act (the GLB Act), most state member banks were authorized to deal in, underwrite, purchase, and sell municipal revenue bonds (12 USC 24 (Seventh)). Effective March 13, 2000, these activities (involving Type I securities) could be conducted by well-capitalized[7] banks, without limitation as to the level of these activities relative to the bank's capital. As a result of the GLB Act amendment, municipal revenue bonds are the equivalent of Type I securities for well-capitalized state member banks.[8] (See SR-01-13.)

The expanded municipal revenue bond authority under the GLB Act necessitates heightened awareness by banks, examiners, and supervisory staff of the particular risks of municipal revenue bond underwriting, dealing, and investment activities. Senior management of a state member bank has the responsibility to ensure that the bank conducts municipal securities underwriting, dealing, and investment activities in a safe and sound manner, in compliance with applicable laws and regulations. Sound risk-management practices are critical. State member banks engaged in municipal securities activities should maintain written policies and procedures governing these activities and make them available to examiners upon request.

Prudent municipal securities investment involves considering and adopting risk-management policies, including appropriate limitations, on the interest-rate, liquidity, price, credit, market, and legal risks in light of the bank's appetite and tolerance for risk. Historically, municipal revenue bonds have had higher default rates than municipal general obligation bonds. The risks of certain industrial development revenue bonds have been akin to the risks of corporate bonds. Therefore, when bondholders are relying on a specific project or private-sector obligation for repayment, banks should conduct a credit analysis, using their normal credit standards, to identify and evaluate the source of repayment before purchasing the bonds. Banks must also perform periodic credit analyses of those securities that remain in the bank's investment portfolio. Prudent banking practices require that management adopt appropriate exposure limits for individual credits and on credits that rely on a similar repayment source; these limits help ensure adequate risk diversification. Furthermore, examiners and other supervisory staff should be aware of the extent to which state laws place further restrictions on municipal securities activities but should defer to state banking regulators on questions of legal authority under state laws and regulations.

For underwriting and dealing activities, the nature and extent of due diligence should be commensurate with the degree of risk posed and the complexity of the proposed activity. Bank dealer activities should be conducted subject to the types of prudential limitations described above but should also be formulated in light of the reputational risk that may accompany underwriting and dealing activities. Senior management and the board of directors should establish credit-quality and position-risk guidelines, including guidelines for concentration risk.

A bank serving as a syndicate manager would be expected to conduct extensive due diligence

7. See the prompt corrective action at 12 USC 1831o and see subpart D of the Federal Reserve's Regulation H (12 CFR 208).

8. The OCC published final amendments to its investment securities regulation (12 CFR 1) on July 2, 2001 (66 *Fed. Reg.* 34784), and further amended this regulation on June 13, 2012 (77 *Fed. Reg.* 35257). State member banks must comply with the requirements of 12 CFR 1 with respect to investments in municipal and other securities.

to mitigate its underwriting risk. Due diligence should include an assessment of the creditworthiness of the issuer and a full analysis of primary and any contingent sources of repayment. Offering documents should be reviewed for their accuracy and completeness, as well as for full disclosure of all of the offering's relevant risks.

CLASSIFICATION AND APPRAISAL OF SECURITIES

This supervisory guidance[9] (2013 Securities Classification Guidance) outlines principles related to the proper classification of securities without relying on ratings issued by nationally recognized statistical rating organizations (external credit ratings) and applies to state member banks and, in principle, to all institutions supervised by the Federal Reserve. Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 requires each federal agency to remove references to, and requirements of reliance on, external credit ratings in any regulation issued by the agency that requires the assessment of the creditworthiness of a security or money market instrument. Therefore, in 2012, the OCC revised its investment security regulations (12 CFR 1) to remove reliance on external credit ratings. Investment 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.

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 thus requires classification. The 2013 Securities Classification Guidance clarifies the classification standards for securities held by an institution and includes illustrated examples that demonstrate when a security is investment grade and when it is not investment grade. See SR-13-18.

UNIFORM AGREEMENT ON THE CLASSIFICATION AND APPRAISAL OF SECURITIES HELD BY DEPOSITORY INSTITUTIONS (AGREEMENT)

This joint Agreement[10] applies creditworthiness standards to the classification of securities and removes the reliance on credit ratings as a determinant of classification.[11] Specific examples are illustrated to demonstrate the appropriate application of these standards to the classification of securities. This Agreement should be used by depository institutions to assist and facilitate the classification of investment securities.

I. The Classification of Assets in Depository Institutions

The agencies' longstanding asset classification definitions have not changed and are provided as an attachment to the Agreement. This Agreement clarifies how the unique characteristics exhibited by investment securities are to be interpreted within these classification categories.

II. The Appraisal of Securities in Depository Institutions

Fundamental credit analysis is central to understanding the risk associated with all assets and should be applied to investment securities as

9. The October 29, 2013, "Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions" was issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (OCC) (the agencies).

10. The agencies are issuing this joint Agreement to depository institutions to revise the 2004 Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (2004 Agreement).

11. For the OCC's final rules, see 77 *Fed. Reg.* 35253 (June 13, 2012). For the OCC's guidance, see 77 *Fed. Reg.* 35259 (June 13, 2012), OCC Bulletin 2012-18, and OCC Bulletin 2012-26. For the Board, refer to SR letter 12-15, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings." For the FDIC, see Permissible Investments for Federal and State Savings Associations: Corporate Debt Securities, 77 *Fed. Reg.* 43151 (July 24, 2012) and "Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security Is Eligible for Investment," 77 *Fed. Reg.* 43155 (July 24, 2012).

part of a pre-purchase and ongoing due diligence process, as discussed in regulatory guidance. Depository institutions are expected to perform an assessment of creditworthiness that is not solely reliant on external credit ratings provided by a Nationally Recognized Statistical Rating Organizations (NRSRO). Such an assessment may include internal-risk analyses and a risk rating framework, third-party research and analytics (which could include NRSRO credit ratings), default statistics, and other sources of data as appropriate for the particular security. The depth of analysis should be a function of the security's risk characteristics, including its size, nature, and complexity. Individual security analysis should form the basis of any classification determination.

A. Investment Grade Debt Securities

A security is investment grade if the issuer of the security has an adequate capacity to meet financial commitments for the life of the asset.[12] An issuer has adequate capacity to meet its financial commitments if the risk of default is low, and the full and timely repayment of principal and interest is expected.[13] A "pass" rating may be supported by an appropriate credit analysis that documents the quality of an investment grade security, as well as ongoing analyses that demonstrate the obligor's continued repayment capacity. Therefore, investment-grade securities will generally not be classified. However, examiners may use discretion to classify a security when justified by available credit-risk information.

B. Sub-investment Grade Debt Securities

Securities that do not meet the investment grade standard, as defined in applicable regulations, and for which the timely repayment of principal and interest is not certain, have investment characteristics that are distinctly or predominantly speculative and are generally subject to classification. For investment securities, the classification should be based on the instrument's worth as an earning asset assuming it is held to maturity. Therefore, the phrase "liquidation of the debt" in the classification definitions is synonymous with "payment of the obligation in full." Accordingly, if payment of the obligation in full is in question, it is no longer investment grade and management should classify the security.

A *Doubtful* classification is appropriate when an asset has experienced significant credit deterioration and decline in fair value, but estimation of impairment involves significant uncertainty because of various pending factors. These factors could include uncertain financial data that may not permit the accurate forecasting of future cash flows or estimating recovery value. The use of the Doubtful classification is an interim measure until information becomes available to substantiate a more appropriate treatment.

C. Classification and Assessment of Other Types of Debt Securities

Some securities with equity-like risk and return profiles can have highly speculative performance characteristics. When determining classification examiners should evaluate such holdings based upon an assessment of each instrument's facts and circumstances. This Agreement does not apply to securities held in trading accounts that are measured at fair value

12. To determine whether a security to be acquired for investment must be investment grade and the applicable definition of "investment grade," a bank or savings association should consult the regulations of its appropriate federal banking agency, e.g., national banks should look to the OCC's rules at 12 CFR 1. For state-chartered financial institutions, the term "investment grade" may be defined differently across laws and regulations issued by each state, and therefore may be subject to restrictions on investments that are more stringent than those in 12 CFR 1. In addition, for corporate investments, federal and state savings associations are required to determine if the security meets the investment permissibility standards under 12 CFR 362 of the FDIC Rules and Regulations. 12 CFR 362 requires that the issuer has adequate capacity to meet all financial commitments under the security for the projected life of the investment. This standard is consistent with the one adopted by the OCC for national banks defined in 12 CFR 1, which was revised to replace the previous definition of "investment grade." State and federal savings associations had to comply with the FDIC's final rule on January 1, 2013. See 77 *Fed. Reg.* 43151 (July 24, 2012). Under the Federal Reserve Act (12 USC 335) and the Federal Reserve'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)) and may only invest in securities to the extent permitted under applicable state law.

13. See, e.g., 12 CFR 1.2(d). Generally, assets that defer payments, even if allowed for in the instrument's contracts, do not meet the "full and timely" repayment standard for investment grade and typically should be classified.

with changes in fair value recognized in current earnings and regulatory capital.[14]

D. Classification of Securities with Credit Deterioration

Depository institutions should continually assess whether securities meet the investment grade standard. Throughout the term of an investment security, its credit-risk profile can decline and improve as credit conditions change. Similarly, an institution's analysis should consider how potential adverse economic conditions can negatively affect an individual security. An institution's management expertise and the sophistication of its risk management and due diligence processes should be commensurate with the complexity of its investment portfolio holdings.

For securities already owned:

Depository institutions should classify a security to accurately reflect its credit-risk profile. For example, a security may meet the criteria for an investment grade rating at purchase and, therefore, be considered a "pass" security. However, as credit conditions deteriorate and ongoing analysis confirms a weakened repayment capacity, the security should be downgraded to Substandard or Doubtful. In situations where the credit condition subsequently improves, the facts and circumstances supported by current analysis may warrant an upgrade to "pass." An upgrade is only appropriate following a period of sustained performance. If the security incurs credit losses,[15] but subsequent analysis shows that all future contractual payments will be received, the security may warrant an upgrade to "pass." Notwithstanding this possibility, securities with realized credit losses do not conform to the investment grade standard and may be subject to restrictions under the agencies' permissible investment regulations or rules governing transfers to affiliates. In situations where credit losses are incurred and analysis does not support the full payment of future contractual amounts, the security cannot be upgraded to "pass."

For potential purchases:

Depository institutions may not purchase investment securities that fail to meet the investment-grade standard as defined by applicable regulations. If pre-purchase analysis reveals previous credit losses in a security under consideration, regardless of its current performance or projected payment analysis, the security does not, and cannot, meet the investment-grade standard.[16] In contrast, if a security experienced credit deterioration and downgrades in the past, but did not sustain actual credit losses, the security's current and projected payment performance may indicate that the security could meet the investment-grade criteria once more. If it is offered for sale at this point and has a history of sustained performance, this security would be considered eligible for purchase by a depository institution.

III. Classification Approach Illustrations

Table 3 that follows outlines examples of how the agencies would apply the uniform classification approach to specific situations. Examiners may use discretion to assess credit risk and assign a classification based on current information, independent of any assigned credit rating.

14. For more information, please refer to the Glossary section of the FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income, which can be found at the following URL: www.fdic.gov/regulations/resources/call/.

15. Credit losses can occur throughout various stages of a security's existence and will depend on a variety of factors, that is, the type of instrument, the ability of the underlying payment source (for example, issuer, underlying asset, and obligors), and the existence of guarantees or credit enhancements. For corporate and municipal obligations, credit losses may represent payment defaults that the issuer does not have the financial capacity to cure. In the case of structured finance products, if a particular class of securities or tranches is no longer fully supported by cash flows from underlying assets, credit losses represent the deficiencies between remaining available cash flow and the principal and interest requirements.

16. One exception to this rule is a security that has undergone a court-supervised legally binding restructure, which has performed for a sustained period following the restructure. This scenario is discussed further in Table 3.

Table 3—Classification Approach Examples

Description of Scenario	*Currently Owned*	*Potential Purchase*[1]
• Credit deterioration caused concerns about potential loss that led to a Substandard classification. • *Credit deterioration is considered temporary.* • Subsequently, the credit condition improved and prior concerns no longer exist. • No actual credit losses were sustained. • Security has performed as agreed to date and is expected to perform to maturity.	Upgrade to "pass."	Eligible for purchase as investment grade.
• Credit deterioration caused concerns about potential loss that led to a Substandard classification. • *An other-than-temporary impairment (OTTI) charge is recognized in earnings; however, all contractual payments were received.* • Subsequent to adverse classification /OTTI determination, the credit condition improved and prior concerns no longer exist. • Current analysis shows that all future contractual payments will be received.	Upgrade to "pass."	Eligible for purchase as investment grade.
• Credit deterioration caused concerns about potential loss that led to a Substandard classification. • *An OTTI charge is recognized in earnings; however, contractual payments are received after recognition of the OTTI charge.* • Subsequently, credit conditions remain weak and analysis shows that *not all* contractual payments are expected to be received.	Substandard classification remains until issuer demonstrates adequate capacity to repay.	Not eligible for purchase as long as current credit conditions remain.

Description of Scenario	*Currently Owned*	*Potential Purchase*[1]
• Credit deterioration caused concerns about potential loss that led to a Substandard classification. • *Credit losses actually incurred.* • A court supervised a legally binding restructure of the obligation. • The issuer demonstrated performance, after the restructure, in accordance with the court approved plan over an appropriate time period. Current analysis shows that *all* future contractual payments will be received.	Upgrade to "pass" after a period of satisfactory performance.	Eligible for purchase as investment grade subsequent to the restructure.
• Credit deterioration caused concerns about potential loss that led to a Substandard classification. • *Credit losses actually incurred.* • Subsequently, the credit condition improved and prior concerns no longer exist. • Subsequent analysis shows that *all* future contractual payments will be received. • Previously incurred credit losses may or may not be recovered.	Substandard classification remains until issuer demonstrates adequate capacity to repay based on sustained period of performance. May be upgraded to "pass" but is not investment grade; considered a nonconforming investment.	Not eligible for purchase; does not meet the criteria for investment grade due to credit losses.
• Credit deterioration caused concerns about potential loss that led to a Substandard classification. • *Credit losses actually incurred.* • Subsequently, credit condition stabilization may, or may not, be evident. • Subsequent analysis shows that *not all* future contractual payments will be received; or analysis does not clearly show no future risk of loss.	Classification remains as long as credit analysis indicates future potential losses. Determine appropriate classification based on credit analysis.	Not eligible for purchase; does not meet the criteria for investment grade due to credit losses.

1. Depository institutions contemplating an investment purchase are not expected to be knowledgeable of the classification and impairment accounting treatment by the seller. However, all salient information leading to investment-grade determination should be gathered and analyzed before a purchase is consummated.

Note to the Agreement: Any upgrade in classification should follow a sustained period of performance and be based on improvement in credit condition and an analysis that supports that all future contractual payments will be received. Generally, the performance period should cover multiple payments as determined by the security's payment structure: monthly, quarterly, annually.

* * * *

CLASSIFICATION OF ASSETS IN EXAMINATIONS

Classification units are designated as Substandard, Doubtful, and Loss. The following definitions apply to assets adversely classified for supervisory purposes:

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

FOREIGN DEBT SECURITIES

The Interagency Country Exposure Review Committee (ICERC) assigns transfer-risk ratings for cross-border exposures. Examiners should use the guidelines in this uniform agreement rather than ICERC transfer-risk ratings in assigning security classifications, except when the ICERC ratings result in a more-severe classification.

CREDIT-RISK-MANAGEMENT FRAMEWORK FOR SECURITIES

When an institution has developed an accurate, robust, and documented credit-risk-management framework to analyze its securities holdings, examiners may choose to depart from the general debt security classification guidelines in favor of individual asset review in determining whether to classify those holdings. A robust credit-risk-management framework entails appropriate pre-acquisition credit due diligence by qualified staff that grades a security's credit risk based on an analysis of the repayment capacity of the issuer and the structure and features of the security. It also involves the ongoing monitoring of holdings to ensure that risk ratings are reviewed regularly and updated in a timely fashion when significant new information is received.

The credit analysis of securities should vary based on the structural complexity of the security, the type of collateral, and external ratings. The credit-risk-management framework should reflect the size, complexity, quality, and risk characteristics of the securities portfolio; the risk appetite and policies of the institution; and the quality of its credit-risk-management staff, and should reflect changes to these factors over time. Policies and procedures should identify the extent of credit analysis and documentation required to satisfy sound credit-risk-management standards.

TRANSFERS OF LOW-QUALITY SECURITIES AND ASSETS

The purchase of low-quality assets by a bank from an affiliated bank or nonbank affiliate is a violation of section 23A of the Federal Reserve Act and Regulation W. The transfer of low-quality securities from one depository institution to another may be done to avoid detection and classification dur-ing regulatory examinations; this type of transfer may be accomplished through participations, purchases or sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Broadly defined, low-quality securities include depreciated or sub-investment-quality securities. Situations in which an institution appears to be concealing low-quality securities to avoid examination scrutiny and possible classification represent an unsafe and unsound activity.

Any situations involving the transfer of low-quality or questionable securities should be brought to the attention of Reserve Bank supervisory personnel who, in turn, should notify the local office of the primary federal regulator of the other depository institution involved in the transaction. For example, if an examiner determines that a state member bank or holding company has transferred or intends to transfer low-quality securities to another depository institution, the Reserve Bank should notify the recipient institution's primary federal regulator of the transfer. The same notification requirement holds true if an examiner determines that a state member bank or holding company has acquired or intends to acquire low-quality securities from another depository institution. This procedure applies to transfers involving savings associations and savings banks, as well as commercial banking organizations.

Situations may arise when transfers of securities are undertaken for legitimate reasons. In these cases, the securities should be properly recorded on the books of the acquiring institution at their fair value on the date of transfer. If the transfer was with the parent holding company or a nonbank affiliate, the records of the affiliate should be reviewed as well.

PERMISSIBLE STOCK HOLDINGS

The purchase of securities convertible into stock at the option of the issuer is prohibited (12 CFR 1.6). Other than as specified in table 4, banks are prohibited from investing in stock.

Table 4—Permitted Stock Holdings by Member Banks*

Type of stock	*Authorizing statute and limitation*
Federal Reserve Bank	Federal Reserve Act, sections 2 and 9 (12 USC 282 and 321) and Regulation I (12 CFR 209). Subscription must equal 6 percent of the bank's capital and surplus, 3 percent paid in.
Safe deposit corporation	12 USC 24. 15 percent of capital and surplus.
Corporation holding bank premises	Federal Reserve Act, section 24A (12 USC 371(d)). 100 percent of capital stock. Limitation includes total direct and indirect investment in bank premises in any form (such as loans). Maximum limitation may be exceeded with permission of the Federal Reserve Bank for state member banks and the Comptroller of the Currency for national banks.
Small business investment company	Small Business Investment Act of August 21, 1958, section 302(b) (15 USC 682(b)). Banks are prohibited from acquiring shares of such a corporation if, upon making the acquisition, the aggregate amount of shares in small business investment companies then held by the bank would exceed 5 percent of its capital and surplus.
Edge Act and agreement corporations and foreign banks	Federal Reserve Act, sections 25 and 25A (12 USC 601 and 618). The aggregate amount of stock held in all such corporations may not exceed 10 percent of the member bank's capital and surplus. Also, the member bank must possess capital and surplus of $1 million or more before acquiring investments pursuant to section 25.
Bank service company	Bank Service Corporation Act of 1958, section 2 (12 USC 1861 and 1862). (Redesignated as Bank Service Company Act.) 10 percent of paid in and unimpaired capital and surplus. Limitation includes total direct and indirect investment in any form. No insured banks shall invest more than 5 percent of their total assets.
Federal National Mortgage Corporation	National Housing Mortgage Association Act of 1934, section 303(f) (12 USC 1718(f)). No limit.
Bank's own stock	12 USC 83. Shares of the bank's own stock may not be acquired or taken as security for loans, except as necessary to prevent loss from a debt previously contracted in good faith. Stock so acquired must be disposed of within six months of the date of acquisition.
Corporate stock acquired through debt previously contracted (DPC) transaction	Case law has established that stock of any corporation debt may be acquired to prevent loss from a debt previously contracted in good faith. See Oppenheimer v. Harriman National Bank & Trust Co. of the City of New York, 301 US 206 (1937). However, if the stock is not disposed of within a reasonable time period, it loses its status as a DPC transaction and becomes a prohibited holding under 12 USC 24(7).
Operations subsidiaries	12 CFR 250.141. Permitted if the subsidiary is to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly.

Type of stock	*Authorizing statute and limitation*
State housing corporation incorporated in the state in which the bank is located	12 USC 24. 5 percent of its capital stock, paid in and unimpaired, plus 5 percent of its unimpaired surplus fund when considered together with loans and commitments made to the corporation.
Agricultural credit corporation	12 USC 24. 20 percent of capital and surplus unless the bank owns over 80 percent. No limit if the bank owns 80 percent or more.
Government National Mortgage Association	12 USC 24. No limit.
Student Loan Marketing Association	12 USC 24. No limit.
Bankers' banks	12 USC 24. 10 percent of capital stock and paid-in and unimpaired surplus. Bankers' banks must be insured by the FDIC, owned exclusively by depository institutions, and engaged solely in providing banking services to other depository institutions and their officers, directors, or employees. Ownership shall not result in any bank's acquiring more than 5 percent of any class of voting securities of the bankers' bank.
Mutual funds	12 USC 24(7). Banks may invest in mutual funds as long as the underlying securities are permissible investments for a bank.
Community development corporation	Federal Reserve Act, section 9, paragraph 23 (12 USC 338a). Up to 10 percent of capital stock and surplus[1] subject to 12 CFR 208.22.

* This information precedes November 2004.

1. Section 208.2(d) of Regulation H defines "capital stock and surplus" to mean tier 1 and tier 2 capital included in a member bank's risk-based capital and the balance of a member bank's allowance for loan and lease losses *not included in its tier 2 capital for calculation of risk-based capital,* based on the bank's most recent consolidated Report of Condition and Income. Section 9 of the Federal Reserve Act (12 USC 338a) provides that the Board has the authority under this law to approve public-welfare or other such investments, up to the sum of 5 percent of paid-in and unimpaired capital stock and 5 percent of unimpaired surplus, unless the Board determines by order that the higher amount will pose no significant risk to the affected deposit insurance fund, and the bank is adequately capitalized. In no case may the aggregate of such investments exceed 10 percent of the bank's combined capital stock and surplus.

LIMITED EQUITY INVESTMENTS

Investing in the equity of nonfinancial companies and lending to private-equity-financed companies (that is, companies financed by private equity) have emerged as increasingly important sources of earnings and business relationships at a number of banking organizations (BOs). In this guidance, the term *private equity* refers to shared-risk investments outside of publicly quoted securities and also covers activities such as venture capital, leveraged buyouts, mezzanine financing, and holdings of publicly quoted securities obtained through these activities. While private equity securities can contribute substantially to earnings, these activities can give rise to increased volatility of both earnings and capital. The supervisory guidance in SR-00-9 on private equity investments and merchant banking activities is concerned with a BO's proper risk-focused management of its private equity investment activities so that these investments do not adversely affect the safety and soundness of the affiliated insured depository institutions.

An institution's board of directors and senior management are responsible for ensuring that the risks associated with private equity activities do not adversely affect the safety and soundness of the banking organization or any other affiliated insured depository institutions. To this end, sound investment and risk-management practices and strong capital positions are critical elements in the prudent conduct of these activities.

Legal and Regulatory Authority

Depository institutions are able to make limited equity investments under the following statutory and regulatory authorities:

- Depository institutions may make equity investments through small business investment corporations (SBICs). Investments made by SBIC subsidiaries are allowed up to a total of 50 percent of a portfolio company's outstanding shares, but can only be made in companies defined as a small business, according to SBIC rules. A bank's aggregate investment in the stock of SBICs is limited to 5 percent of the bank's capital and surplus.
- Under Regulation K, which implements sections 25 and 25A of the Federal Reserve Act (FRA) and section 4(c)(13) of the Bank Holding Company Act of 1956 (BHC Act), a depository institution may make portfolio investments in foreign companies, provided the investments do not in the aggregate exceed 25 percent of the tier 1 capital of the bank holding company. In addition, individual investments must not exceed 19.9 percent of a portfolio company's voting shares or 40 percent of the portfolio company's total equity.[17]

Equity investments made under the authorities listed above may be in publicly traded securities or privately held equity interests. The investment may be made as a direct investment in a specific portfolio company, or it may be made indirectly through a pooled investment vehicle, such as a private equity fund.[18] In general, private equity funds are investment companies, typically organized as limited partnerships, that pool capital from third-party investors to invest in shares, assets, and ownership interests in companies for resale or other disposition. Private-equity-fund investments may provide seed or early-stage investment funds to start-up companies or may finance changes in ownership, middle-market business expansions, and mergers and acquisitions.

17. Shares of a corporation held in trading or dealing accounts or under any other authority are also included in the calculation of a depository institution's investment. Portfolio investments of $25 million or less can be made without prior notice to the Board. See Regulation K for more detailed information.

18. For additional stock holdings that state member banks are authorized to hold, see table 4.

Oversight by the Board of Directors and Senior Management

Equity investment activities require the active oversight of the board of directors and senior management of the depository institution that is conducting the private equity investment activities. The board should approve portfolio objectives, overall investment strategies, and general investment policies that are consistent with the institution's financial condition, risk profile, and risk tolerance. Portfolio objectives should address the types of investments, expected business returns, desired holding periods, diversification parameters, and other elements of sound investment-management oversight. Board-approved objectives, strategies, policies, and procedures should be documented and clearly communicated to all the personnel involved in their implementation. The board should actively monitor the performance and risk profile of equity investment business lines in light of the established objectives, strategies, and policies.

The board also should ensure that there is an effective management structure for conducting the institution's equity activities, including adequate systems for measuring, monitoring, controlling, and reporting on the risks of equity investments. The board should approve policies that specify lines of authority and responsibility for both acquisitions and sales of investments. The board should also approve (1) limits on aggregate investment and exposure amounts; (2) the types of investments (for example, direct and indirect, mezzanine financing, start-ups, seed financing); and (3) appropriate diversification-related aspects of equity investments such as industry, sector, and geographic concentrations.

For its part, senior management must ensure that there are adequate policies, procedures, and management information systems for managing equity investment activities on a day-to-day and longer-term basis. Management should set clear lines of authority and responsibility for making and monitoring investments and for managing risk. Management should ensure that an institution's equity investment activities are conducted by competent staff whose technical knowledge and experience are consistent with the scope of the institution's activities.

Management of the Investment Process

Depository institutions engaging in equity investment activities should have a sound process for executing all elements of investment management, including initial due diligence, periodic reviews of holdings, investment valuation, and realization of returns. This process requires appropriate policies, procedures, and management information systems, the formality of which should be commensurate with the scope, complexity, and nature of an institution's equity investment activities. The supervisory review should be risk-focused, taking into account the institution's stated tolerance for risk, the ability of senior management to govern these activities effectively, the materiality of activities in comparison to the institution's risk profile, and the capital position of the institution.

Depository institutions engaging in equity investment activities require effective policies that (1) govern the types and amounts of investments that may be made, (2) provide guidelines on appropriate holding periods for different types of investments, and (3) establish parameters for portfolio diversification. Investment strategies and permissible types of investments should be clearly identified. Portfolio-diversification policies should identify factors pertinent to the risk profile of the investments being made, such as industry, sector, geographic, and market factors. Policies establishing expected holding periods should specify the general criteria for liquidation of investments and guidelines for the divestiture of an underperforming investment. Decisions to liquidate underperforming investments are necessarily made on a case-by-case basis considering all relevant factors. Policies and procedures, however, should require more frequent review and analysis for investments that are performing poorly or that have been in a portfolio for a considerable length of time, as compared with the other investments overall.

Policies and Limits

Policies should identify the aggregate exposure that the institution is willing to accept, by type and nature of investment (for example, direct or indirect, industry sectors). The limits should include funded and unfunded commitments. Formal and clearly articulated hedging policies and strategies should identify limits on hedged exposures and permissible hedging instruments.

Procedures

Management and staff compensation play a critical role in providing incentives and controlling risks within a private equity business line. Clear policies should govern compensation arrangements, including co-investment structures and staff sales of portfolio company interests.

Institutions have different procedures for assessing, approving, and reviewing investments based on the size, nature, and risk profile of an investment. The procedures used for direct investments may be different than those used for indirect investments made through private equity funds. For example, different levels of due diligence and senior management approvals may be required. When constructing management infrastructures for conducting these investment activities, management should ensure that operating procedures and internal controls appropriately reflect the diversity of investments.

The potential diversity in investment practice should be recognized when conducting supervisory reviews of the equity investment process. The supervisory focus should be on the appropriateness of the process employed relative to the risk of the investments made and on the materiality of this business line to the overall soundness of the depository institution, as well as the potential impact on affiliated depository institutions. The procedures employed should include the following:

- *Investment analysis and approvals, including well-founded analytical assessments of investment opportunities and formal investment-approval processes.*
  The methods and types of analyses conducted should be appropriately structured to adequately assess the specific risk profile, industry dynamics, management, specific terms and conditions of the investment opportunity, and other relevant factors. All elements of the analytical and approval processes, from initial review through the formal investment decision, should be documented and clearly

understood by the staff conducting these activities.

The evaluation of existing and potential investments in private equity funds should involve an assessment of the adequacy of a fund's structure. Consideration should be given to the (1) management fees, (2) carried interest and its computation on an aggregate portfolio basis,[19] (3) sufficiency of capital commitments that are provided by the general partners in providing management incentives, (4) contingent liabilities of the general partner, (5) distribution policies and wind-down provisions, and (6) performance benchmarks and return-calculation methodologies.

- *Investment-risk ratings.*
  Internal risk ratings should assign each investment a rating based on factors such as the nature of the company, strength of management, industry dynamics, financial condition, operating results, expected exit strategies, market conditions, and other pertinent factors. Different rating factors may be appropriate for indirect investments and direct investments.
- *Periodic and timely investment strategy and performance (best, worst, and probable case assessment) reviews of equity investments, conducted at the individual and portfolio levels.*
  Management should ensure that periodic and timely review of the institution's equity investments takes place at both individual-investment and portfolio levels. Depending on the size, complexity, and risk profile of the investment, reviews should, when appropriate, include factors such as—
  — the history of the investment, including the total funds approved;
  — commitment amounts, principal-cash-investment amounts, cost basis, carrying value, major-investment cash flows, and supporting information including valuation rationales and methodologies;
  — the current actual percentage of ownership in the portfolio company on both a diluted and undiluted basis;
  — a summary of recent events and current outlook;
  — the recent financial performance of portfolio companies, including summary compilations of performance and forecasts, historical financial results, current and future plans, key performance metrics, and other relevant items;
  — internal investment-risk ratings and rating-change triggers;
  — exit strategies, both primary and contingent, and expected internal rates of return upon exit; and
  — other pertinent information for assessing the appropriateness, performance, and expected returns of investments.

  Portfolio reviews should include an aggregation of individual investment-risk and performance ratings; an analysis of appropriate industry, sector, geographic, and other pertinent concentrations; and total portfolio valuations. Portfolio reports that contain the cost basis, carrying values, estimated fair values, valuation discounts, and other factors summarizing the status of individual investments are integral tools for conducting effective portfolio reviews. Reports containing the results of all reviews should be available to supervisors for their inspection.

  Given the inherent uncertainties in equity investment activities, institutions should include in their periodic reviews consideration of the best case, worst case, and probable case assessments of investment performance. These reviews should evaluate changes in market conditions and the alternative assumptions used to value investments—including expected and contingent exit strategies. Major assumptions used in valuing investments and forecasting performance should be identified. These assessments need not be confined to quantitative analyses of potential losses, but may also include qualitative analyses. The formality and sophistication of investment reviews should be appropriate for the overall level of risk the depository institution incurs from this business line.
- *Assessment of the equity investment valuation and accounting policies and the procedures used, their impact on earnings, and the extent of their compliance with generally accepted accounting principles (GAAP).*
  Valuation and accounting policies and procedures can have a significant impact on the earnings of institutions engaged in equity investment activities. Many equity investments are made in privately held companies, for which independent price quotations are either unavailable or not available in sufficient volume to provide meaningful liquidity or a

19. The carried interest is the share of a partnership's return that is received by the general partners or investment advisers.

market valuation. Valuations of some equity investments may involve a high degree of judgment on the part of management or the skillful use of peer comparisons. Similar circumstances may exist for publicly traded securities that are thinly traded or subject to resale and holding-period restrictions, or when the institution holds a significant block of a company's shares. It is of paramount importance that an institution's policies and procedures on accounting and valuation methodologies for equity investments be clearly articulated.

Under GAAP, equity investments held by investment companies, held by broker-dealers, or maintained in the trading account are reported at fair value, with any unrealized appreciation or depreciation included in earnings and flowing to tier 1 capital. For some holdings, fair value may reflect adjustments for liquidity and other factors.

Equity investments that are not held in investment companies, by broker-dealers, or in the trading account and that have a readily determinable fair value (quoted market price) are generally reported as available-for-sale (AFS). They are marked to market with unrealized appreciation or depreciation recognized in GAAP-defined "comprehensive income" but not earnings. Appreciation or depreciation flows to equity, but, for regulatory capital purposes only, depreciation is included in tier 1 capital.[20] Equity investments without readily determinable fair values generally are held at cost, subject to write-downs for impairments to the value of the asset. Impairments of value should be promptly and appropriately recognized and written down.

In determining fair value, the valuation methodology plays a critical role. Formal valuation and accounting policies should be established for investments in public companies; direct private investments; indirect fund investments; and, where appropriate, other types of investments with special characteristics. When establishing valuation policies, institutions should consider market conditions, taking account of lockout provisions, the restrictions of Securities and Exchange Commission Rule 144, liquidity features, the dilutive effects of warrants and options, and industry characteristics and dynamics.

Accounting and valuation of equity investments should be subject to regular periodic review. In all cases, valuation reviews should produce documented audit trails that are available to supervisors and auditors. These reviews should assess the consistency of the methodologies used in estimating fair value.

Accounting and valuation treatments should be assessed in light of their potential for abuse, such as through the inappropriate management or manipulation of reported earnings on equity investments. For example, high valuations may produce overstatements of earnings through gains and losses on investments reported at "fair value." On the other hand, inappropriately understated valuations can provide vehicles for smoothing earnings by recognizing gains on profitable investments when an institution's earnings are otherwise under stress. While reasonable people may disagree on valuations given to illiquid private equity investments, institutions should have rigorous valuation procedures that are applied consistently.

Increasingly, equity investments are contributing to an institution's earnings. The potential impact of these investments on the composition, quality, and sustainability of overall earnings should be appropriately recognized and assessed by both management andsupervisors.

- *A review of assumed and actual equity-investment exit strategies and the extent of their impact on the returns and reported earnings.*
  The principal means of exiting an equity investment in a privately held company include initial public stock offerings, sales to other investors, and share repurchases. An institution's assumptions on exit strategies can significantly affect the valuation of the investment. Management should periodically review investment exit strategies, with particular focus on larger or less-liquid investments.

- *Policies and procedures governing the sale, exchange, transfer, or other disposition of equity investments.*
  Policies and procedures to govern the sale, exchange, transfer, or other disposition of the institution's investments should state clearly the levels of management or board approval required for the disposition of investments.

20. Under the risk-based capital rule, supplementary (tier 2) capital may include up to 45 percent of pretax unrealized holding gains (that is, the excess, if any, of the fair value over historical cost) on AFS equity securities with readily determinable fair values.

- *Internal methods for allocating capital based on the risk inherent in the equity investment activities, including the methods for identifying all material risks and their potential impact on the safety and soundness of the institution.*
  Consistent with SR-99-18, depository institutions that are conducting material equity investment activities should have internal methods for allocating economic capital. These methods should be based on the risk inherent in the equity investment activities, including the identification of all material risks and their potential impact on the institution. Organizations that are substantially engaged in these investment activities should have strong capital positions supporting their equity investments. The economic capital that organizations allocate to their equity investments should be well in excess of the current regulatory minimums applied to lending activities. The amount of percentage of capital dedicated to the equity investment business line should be appropriate to the size, complexity, and financial condition of the institution. Assessments of capital adequacy should cover not only the institution's compliance with regulatory capital requirements and the quality of regulatory capital, but should also include an institution's methodologies for internally allocating economic capital to this business line.

Internal Controls

An adequate system of internal controls, with appropriate checks and balances and clear audit trails, is critical to conducting equity investment activities effectively. Appropriate internal controls should address all the elements of the investment-management process. The internal controls should focus on the appropriateness of existing policies and procedures; adherence to policies and procedures; and the integrity and adequacy of investment valuations, risk identification, regulatory compliance, and management reporting. Any departures from policies and procedures should be documented and reviewed by senior management, and this documentation should be available for examiner review.

As with other financial activities, the assessments of an organization's compliance with both written and implied policies and procedures should be independent of line decision-making functions to the fullest extent possible. When fully independent reviews are not possible in smaller, less-complex institutions, alternative checks and balances should be established. These alternatives may include random internal audits, reviews by senior management who are independent of the function, or the use of outside third parties.

Documentation

Documentation of key elements of the investment process, including initial due diligence, approval reviews, valuations, and dispositions, is an integral part of any private equity investment internal control system. This documentation should be accessible to supervisors.

Legal Compliance

An institution's internal controls should focus on compliance with all federal laws and regulations that are applicable to the institution's investment activities. Regulatory compliance requirements, in particular, should be incorporated into internal controls so managers outside of the compliance or legal functions understand the parameters of permissible investment activities.

To ensure compliance with federal securities laws, institutions should establish policies, procedures, and other controls addressing insider trading. A "restricted list" of securities for which the institution has inside information is one example of a widely used method for controlling the risk of insider trading. In addition, control procedures should be in place to ensure that appropriate reports are filed with functional regulators.

The limitations in sections 23A and 23B of the FRA, which deal with transactions between a depository institution and its affiliates, are presumed by the Gramm-Leach-Bliley Act (GLB Act) to apply to certain transactions between a depository institution and any portfolio company in which an affiliate of the institution owns at least a 15 percent equity interest. This ownership threshold is lower than the ordinary definition of an affiliate, which is typically 25 percent.

Compensation

Often, key employees in the private equity investment units of banking organizations may co-invest in the direct or fund investments made by the unit. These co-investment arrangements can be an important incentive and risk-control technique, and they can help to attract and retain qualified management. However, "cherry picking," or selecting only certain investments for employee participation while excluding others, should be discouraged.

The employees' co-investment may be funded through loans from the depository institution or its affiliates, which, in turn, would hold a lien against the employees' interests. The administration of the compensation plan should be appropriately governed pursuant to formal agreements, policies, and procedures. Among other matters, policies and procedures should address the terms and conditions of employee loans and the sales of participants' interests before the release of the lien.

Disclosure of Equity Investment Activities

Given the important role that market discipline plays in controlling risk, institutions should ensure that they adequately disclose the information necessary for the markets to assess the institution's risk profile and performance in this business line. Indeed, it is in the institution's interest, as well as that of its creditors and shareholders, to publicly disclose information about earnings and risk profiles. Institutions are encouraged to disclose in public filings information on the type and nature of investments, portfolio concentrations, returns, and their contributions to reported earnings and capital. Supervisors should fully review and use these disclosures, as well as periodic regulatory reports filed by publicly held banking organizations, as part of the information they review routinely. The following topics are relevant for public disclosure, though disclosures on each of these topics may not be appropriate, relevant, or sufficient in every case:

- the size of the portfolio
- the types and nature of investments (for example, direct or indirect, domestic or international, public or private, equity or debt with conversion rights)
- initial cost, carrying value, and fair value of investments and, when applicable, comparisons to publicly quoted share values of portfolio companies
- the accounting techniques and valuation methodologies, including key assumptions and practices affecting valuation and changes in those practices
- the realized gains (or losses) arising from sales and unrealized gains (or losses)
- insights regarding the potential performance of equity investments under alternative market conditions

Lending to or Engaging in Other Transactions with Portfolio Companies

Additional risk-management issues may arise when a depository institution or an affiliate lends to or has other business relationships with (1) a company in which the depository institution or an affiliate has invested (that is, a portfolio company), (2) the general partner or manager of a private equity fund that has also invested in a portfolio company, or (3) a private-equity-financed company in which the banking institution does not hold a direct or indirect ownership interest but which is an investment or portfolio company of a general partner or fund manager with which the banking organization has other investments. Given the potentially higher-than-normal risk attributes of these lending relationships, institutions should devote special attention to ensuring that the terms and conditions of such relationships are at arm's length and are consistent with the lending policies and procedures of the institution. Similar issues may arise in the context of derivatives transactions with or guaranteed by portfolio companies and general partners. Lending and other business transactions between an insured depository institution and a portfolio company that meet the definition of an affiliate must be negotiated on an arm's-length basis, in accordance with section 23B of the FRA.

When a depository institution lends to a private-equity-financed company in which it has no equity interest but in which the borrowing company is a portfolio investment of private equity fund managers or general partners with which the institution may have other private-equity-related relationships, care must be taken to ensure that the extension of credit is conducted on reasonable terms. In some cases, lenders may wrongly assume that the general partners or another third party implicitly guarantees or stands behind such credits. Reliance on implicit guarantees or comfort letters should not substitute for reliance on a sound borrower that is expected to service its debt with its own resources. As with any type of credit extension, absent a written contractual guarantee, the credit quality of a private equity fund manager, general partner, or other third party should not be used to upgrade the internal credit-risk rating of the borrower company or to prevent the classification or special mention of a loan.

When an institution lends to a portfolio company in which it has a direct or an indirect interest, implications arise under sections 23A and 23B of the FRA, which govern credit-related transactions and asset purchases between a depository institution and its affiliates. Section 23A applies to transactions between a depository institution and any company in which the institution's holding company or shareholders own at least 25 percent of the company's voting shares. The GLB Act extends this coverage by establishing a presumption that a portfolio company is an affiliate of a depository institution if the financial holding company (FHC) uses the merchant banking authority of the GLB Act to own or control more than 15 percent of the equity of the company. Institutions should obtain the assistance of counsel in determining whether such issues exist or would exist if loans were extended to a portfolio company, general partner, or manager. Supervisors, including examiners, should ensure that the institution has conducted a proper review of these issues to avoid violations of law or regulations.

INVESTMENT SECURITIES' RISKS

Market Risk

Market risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution. Although many banking institutions focus on carrying values and reported earnings when assessing market risk at the institutional level, other measures focusing on total returns and changes in economic or fair values better reflect the potential market-risk exposure of institutions, portfolios, and individual instruments. Changes in fair values and total returns directly measure the effect of market movements on the economic value of an institution's capital and provide significant insights into their ultimate effects on the institution's long-term earnings. Institutions should manage and control their market risks using both an earnings and an economic-value approach, and at least on an economic or fair-value basis.

When evaluating capital adequacy, examiners should consider the effect of changes in market rates and prices on the economic value of the institution by evaluating any unrealized losses in an institution's securities or derivative positions. This evaluation should assess the ability of the institution to hold its positions and function as a going concern if recognition of unrealized losses would significantly affect the institution's capital ratios. Examiners also should consider the impact that liquidating positions with unrealized losses may have on the institution's prompt-corrective-action capital category.

Market-risk limits should be established for both the acquisition and ongoing management of an institution's securities and derivative holdings and, as appropriate, should address exposures for individual instruments, instrument types, and portfolios. These limits should be integrated fully with limits established for the entire institution. At the institutional level, the board of directors should approve market-risk exposure limits that specify percentage changes in the economic value of capital and, when applicable, in the projected earnings of the institution under various market scenarios. Similar and complementary limits on the volatility of prices or fair value should be established at the appropriate instrument, product-type, and portfolio levels, based on the institution's willingness to accept market risk. Limits on the variability of effective maturities may also be desirable for certain types of instruments or portfolios.

The scenarios an institution specifies for assessing the market risk of its securities and derivative products should be sufficiently rigorous to capture all meaningful effects of any options. For example, in assessing interest-rate risk, scenarios such as 100, 200, and 300 basis point parallel shifts in yield curves should be considered as well as appropriate nonparallel shifts in structure to evaluate potential basis, volatility, and yield curve risks.

Accurately measuring an institution's market risk requires timely information about the current carrying and market values of its securities and derivative holdings. Accordingly, institutions should have market-risk measurement systems commensurate with the size and nature of these holdings. Institutions with significant holdings of highly complex instruments should ensure that they have independent means to value their positions. Institutions using internal models to measure risk should validate the models according to the standards in SR-11-7. This should include a periodic review of all elements of the modeling process, including its assumptions and risk-measurement techniques. Institutions relying on third parties for market-risk measurement systems and analyses should fully understand the assumptions and techniques used by the third party.

Institutions should evaluate the market-risk exposures of their securities and derivative positions and report this information to their boards of directors regularly, not less frequently than each quarter. These evaluations should assess trends in aggregate market-risk exposure and the performance of portfolios relative to their established objectives and risk constraints. They also should identify compliance with board-approved limits and identify any exceptions to established standards. Examiners should ensure that institutions have mechanisms to detect and adequately address exceptions to limits and guidelines. Examiners should also determine that management reporting on market risk appropriately addresses potential exposures to basis risk, yield curve changes, and other factors pertinent to the institution's holdings. In this connection, examiners should assess an institution's compliance with broader guidance for managing interest-rate risk in a consolidated organization.

Complex and illiquid instruments often involve greater market risk than broadly traded, more liquid securities. Often, this higher potential market risk arising from illiquidity is not captured by standardized financial-modeling techniques. This type of risk is particularly acute for instruments that are highly leveraged or that are designed to benefit from specific, narrowly defined market shifts. If market prices or rates do not move as expected, the demand for these instruments can evaporate. When examiners encounter such instruments, they should review how adequately the institution has assessed its potential market risks. If the risks from these instruments are material, the institution should have a well-documented process for stress testing their value and liquidity assumptions under a variety of market scenarios.

Liquidity Risk

Banks face two types of liquidity risk in their securities and derivative activities: risks related to specific products or markets and risks related to the general funding of their activities. The former, market-liquidity risk, is the risk that an institution cannot easily unwind or offset a particular position at or near the previous market price because of inadequate market depth or disruptions in the marketplace. The latter, funding-liquidity risk, is the risk that the bank will be unable to meet its payment obligations on settlement dates. Since neither type of liquidity risk is unique to securities and derivative activities, management should evaluate these risks in the broader context of the institution's overall liquidity.

When specifying permissible securities and derivative instruments to accomplish established objectives, institutions should take into account the size, depth, and liquidity of the markets for specific instruments, and the effect these characteristics may have on achieving an objective. The market liquidity of certain types of instruments may make them entirely inappropriate for achieving certain objectives. Moreover, institutions should consider the effects that market risk can have on the liquidity of different types of instruments. For example, some government-agency securities may have embedded options that make them highly illiquid during periods of market volatility and stress, despite their high credit rating. Accordingly, institutions should clearly articulate the market-liquidity characteristics of instruments to be used in accomplishing institutional objectives.

Operating and Legal Risks

Operating risk is the risk that deficiencies in information systems or internal controls will result in unexpected loss. Some specific sources of operating risk include inadequate procedures, human error, system failure, or fraud. Inaccurately assessing or controlling operating risks is one of the more likely sources of problems facing institutions involved in securities and derivative activities.

Adequate internal controls are the first line of defense in controlling the operating risks involved in an institution's securities and derivative activities. Of particular importance are internal controls to ensure that persons executing transactions are separated from those individuals responsible for processing contracts, confirming transactions, controlling various clearing accounts, approving the accounting methodology or entries, and performing revaluations.

Institutions should have approved policies, consistent with legal requirements and internal policies, that specify documentation requirements for transactions and formal procedures for saving and safeguarding important documents. Relevant personnel should fully understand the requirements. Examiners should also consider the extent to which institutions evaluate and control operating risks through internal audits, stress testing, contingency planning, and other managerial and analytical techniques.

An institution's operating policies should establish appropriate procedures to obtain and maintain possession or control of instruments purchased. Institutions should ensure that transactions consummated orally are confirmed as soon as possible. As noted earlier in this section, banking organizations should, to the extent possible, seek to diversify the firms used for their safekeeping arrangements to avoid concentrations of assets or other types of risk.

Legal risk is the risk that contracts are not legally enforceable or documented correctly. This risk should be limited and managed through policies developed by the institution's legal counsel. At a minimum, guidelines and processes should be in place to ensure the enforceability of counterparty agreements. Examiners should determine whether an institution is adequately evaluating the enforceability of its agreements before individual transactions are consummated. Institutions should also ensure that the counterparty has sufficient authority to enter into the transaction and that the terms of the agreement are legally sound. Institutions should further ascertain that their netting agreements are adequately documented, have been executed properly, and are enforceable in all relevant jurisdictions. Institutions should know relevant tax laws and interpretations governing the use of netting instruments.

An institution's policies should also provide conflict-of-interest guidelines for employees who are directly involved in purchasing securities from and selling securities to securities dealers on behalf of their institution. These guidelines should ensure that all directors, officers, and employees act in the best interest of the institution. The board of directors may wish to adopt policies prohibiting these employees from engaging in personal securities transactions with the same securities firms the institution uses without the specific prior approval of the board. The board of directors may also wish to adopt a policy applicable to directors, officers, and employees that restricts or prohibits them from receiving gifts, gratuities, or travel expenses from approved securities dealer firms and their personnel.

INTERNATIONAL DIVISION INVESTMENTS

The same types of instruments exist in international banking as in domestic banking. Securities and derivative contracts may be acquired by a bank's international division and overseas branches for its own account, and foreign equity investments may be held by the bank directly or through Edge Act corporations. The investments held by most international divisions are predominately securities issued by various governmental entities of the countries in which the bank's foreign branches are located. These investments are held for a variety of purposes:

- They are required by various local laws.
- They are used to meet foreign reserve requirements.
- They result in reduced tax liabilities.
- They enable the bank to use new or increased re-discount facilities or benefit from greater deposit or lending authorities.
- They are used by the bank as an expression of "goodwill" toward a country.

The examiner should be familiar with the applicable sections of Regulation K (12 CFR 211) governing a member bank's international investment holdings, as well as other regulations discussed in this section. Because of the mandatory investment requirements of some countries, securities held cannot always be as "liquid" and "readily marketable" as required in domestic banking. However, the amount of a bank's "mandatory" holdings will normally be a relatively small amount of its total investments or capital funds.

A bank's international division may also hold securities strictly for investment purposes; these are expected to provide a reasonable rate of return commensurate with safety considerations. As with domestic investment securities, the bank's safety must take precedence, followed by liquidity and marketability. Securities held by international divisions are considered to be liquid if they are readily convertible into cash at their approximate carrying value. They are marketable if they can be sold in a very short time at a price commensurate with yield and quality. Speculation in marginal foreign securities to generate more favorable yields is an unsound banking practice and should be discouraged.

Banks are generally prohibited from investing in stocks. However, a number of exceptions (detailed earlier in this section) are often applicable to the international division. For example, the bank may, under section 24A of the Federal Reserve Act (12 USC 371d), hold stock in overseas corporations that hold title to foreign bank premises. Both stock and other securities holdings are permissible under certain circumstances and in limited amounts under section 211.4 of Regulation K—Permissible Activities and Investments of Foreign Branches of Member Banks (12 CFR 211). Other sections of Regulation K permit the bank to make equity investments in Edge Act and agreement corporations and in foreign banks, subject to certain limitations.

Standard & Poor's, Moody's, and other publications from U.S. rating-services rate Canadian and other selected foreign securities that are authorized for U.S. commercial bank investment purposes under 12 USC 24 (Seventh). However, in many other countries, securities-rating services are limited or nonexistent. When they do exist, the ratings are only indicative and should be supplemented with additional information on legality, credit soundness, marketability, and foreign-exchange and country-risk factors. The opinions of local attorneys are often the best source of determining whether a particular foreign security has the full faith and credit backing of a country's government.

Sufficient analytical data must be provided to the bank's board of directors and senior management so they can make informed judgments about the effectiveness of the international division's investment policy and procedures. The institution's international securities and derivative contracts should be included on all board and senior management reports detailing domestic securities and derivative contracts received. These reports should be timely and sufficiently detailed to allow the board of directors and senior management to understand and assess the credit, market, and liquidity risks facing the institution and its securities and derivative positions.

ACCOUNTING FOR SECURITIES PORTFOLIOS

A single class of a financial instrument that can meet trading, investment, or hedging objectives may have a different accounting treatment applied to it, depending on management's purpose for holding it. Therefore, an examiner reviewing investment or trading activities should be familiar with the different accounting methods to ensure that the particular accounting treatment being used is appropriate for the purpose of holding a financial instrument and the economic substance of the related transaction.

The accounting principles that apply to securities portfolios, including trading accounts, and to derivative instruments are complex and have evolved over time—both with regard to authoritative standards and related banking practices. Examiners should consult the sources of generally accepted accounting principles (GAAP); FASB ASC 320, Investments—Debt and Equity Securities; and the reporting requirements in the bank Call Report (referred to in this section) for more detailed guidance in these areas.

Examiners should be aware that accounting practices in foreign countries may differ from the accounting principles followed in the United States. Nevertheless, foreign institutions are required to submit regulatory reports prepared in accordance with U.S. banking agency regulatory reporting instructions, which incorporate GAAP.

Treatment under FASB ASC TOPIC 320, formerly FASB Statement No. 115

In May 1993, the Financial Accounting Standards Board issued Statement of Financial

Accounting Standards No. 115, "Accounting for Certain Investments in Debt and Equity Securities."[21] FASB 115 supersedes FASB 12, "Accounting for Certain Marketable Securities," and related interpretations. It also amends other standards, including FASB 65, "Accounting for Certain Mortgage-Banking Activities," to eliminate mortgage-backed securities from that statement's scope. FASB 115 addresses investments in equity securities that have readily determinable fair values and all investments in debt securities.[22] The accounting standard was effective for fiscal years beginning after December 15, 1993, for regulatory reporting and financial reporting purposes. It was to be initially applied as of the beginning of an institution's fiscal year and cannot be applied retroactively to prior years' financial statements. Investments subject to the standard are to be classified in three categories and accounted for as follows:

- *Held-to-maturity account*. Debt securities that the institution has the positive intent and ability to hold to maturity are classified as held-to-maturity securities and reported at amortized cost.
- *Trading account*. Debt and equity securities that are bought and held principally for the purpose of selling them in the near term are classified as trading securities and reported at fair value, with unrealized gains and losses included in earnings. Trading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price.
- *Available-for-sale account*. Debt and equity securities not classified as either held-to-maturity securities or trading securities are classified as available-for-sale securities and reported at fair value, with unrealized gains and losses excluded from earnings and reported as a net amount in a separate component of shareholders' equity.

Under FASB 115, mortgage-backed securities that are held for sale in conjunction with mortgage-banking activities should be reported at fair value in the trading account. The standard does not apply to loans, including mortgage loans, that have not been securitized.

Upon the acquisition of a debt or equity security, an institution must place the security into one of the above three categories. At each reporting date, the institution must reassess whether the balance-sheet designation continues to be appropriate. Proper classification of securities is a key examination issue. (See SR-94-25 and SR-93-72; see also SR-96-32.)

FASB 115 recognizes that certain changes in circumstances may cause the institution to change its intent to hold a certain security to maturity without calling into question its intent to hold other debt securities to maturity in the future. Thus, the sale or transfer of a held-to-maturity security due to one of the following changes in circumstances will not be viewed as inconsistent with its original balance-sheet classification:

- evidence of a significant deterioration in the issuer's creditworthiness
- a change in tax law that eliminates or reduces the tax-exempt status of interest on the debt security (but not a change in tax law that revises the marginal tax rates applicable to interest income)
- a major business combination or major disposition (such as the sale of a segment) that necessitates the sale or transfer of held-to-maturity securities to maintain the institution's existing interest-rate risk position or credit-risk policy
- a change in statutory or regulatory requirements that significantly modifies either what constitutes a permissible investment or the maximum level of investments in certain kinds

21. FASB 115 does not apply to investments in equity securities accounted for under the equity method or to investments in consolidated subsidiaries. This statement does not apply to institutions whose specialized accounting practices include accounting for substantially all investments in debt and equity securities at market value or fair value, with changes in value recognized in earnings (income) or in the change in net assets. Examples of those institutions are brokers and dealers in securities, defined-benefit pension plans, and investment companies.

22. FASB 115 states that the fair value of an equity security is readily determinable if sales prices or bid-asked quotations are currently available on a securities exchange registered with the SEC or in the over-the-counter market, provided that those prices or quotations for the over-the-counter market are publicly reported by the FINRA Automated Quotations systems or by the National Quotation Bureau, Inc. Restricted stock does not meet that definition.

The fair value of an equity security traded only in a foreign market is readily determinable if that foreign market is of a breadth and scope comparable to one of the U.S. markets referred to above. The fair value of an investment in a mutual fund is readily determinable if the fair value per share (unit) is determined and published and is the basis for current transactions.

of securities, thereby causing an institution to dispose of a held-to-maturity security
- a significant increase by the regulator in the industry's capital requirements that causes the institution to downsize by selling held-to-maturity securities
- a significant increase in the risk weights of debt securities used for regulatory risk-based capital purposes

Furthermore, FASB 115 recognizes that other events that are isolated, nonrecurring, and unusual for the reporting institution and could not have been reasonably anticipated may cause the institution to sell or transfer a held-to-maturity security without necessarily calling into question its intent to hold other debt securities to maturity. However, all sales and transfers of held-to-maturity securities must be disclosed in the footnotes to the financial statements.

An institution must not designate a debt security as held-to-maturity if the institution has the intent to hold the security for only an indefinite period. Consequently, a debt security should not, for example, be designated as held-to-maturity if the banking organization or other company anticipates that the security would be available to be sold in response to—

- changes in market interest rates and related changes in the security's prepayment risk,
- needs for liquidity (for example, due to the withdrawal of deposits, increased demand for loans, surrender of insurance policies, or payment of insurance claims),
- changes in the availability of and the yield on alternative investments,
- changes in funding sources and terms, or
- changes in foreign-currency risk.

According to FASB 115, an institution's asset-liability management may take into consideration the maturity and repricing characteristics of all investments in debt securities, including those held to maturity or available for sale, without tainting or casting doubt on the standard's criterion that there be a "positive intent to hold until maturity."[23] However, securities should not be designated as held-to-maturity if they may be sold. Further, liquidity can be derived from the held-to-maturity category by the use of repurchase agreements that are designated as financings, but not sales.

Transfers of a security between investment categories should be accounted for at fair value. FASB 115 requires that at the date of the transfer, the security's unrealized holding gain or loss must be accounted for as follows:

- For a security transferred from the trading category, the unrealized holding gain or loss at the date of the transfer will have already been recognized in earnings and should not be reversed.
- For a security transferred into the trading category, the unrealized holding gain or loss at the date of the transfer should be recognized in earnings immediately.
- For a debt security transferred into the available-for-sale category from the held-to-maturity category, the unrealized holding gain or loss at the date of the transfer should be recognized in a separate component of shareholders' equity.
- For a debt security transferred into the held-to-maturity category from the available-for-sale category, the unrealized holding gain or loss at the date of the transfer should continue to be reported in a separate component of shareholders' equity but should be amortized over the remaining life of the security as an adjustment of its yield in a manner consistent with the amortization of any premium or discount.

Transfers from the held-to-maturity category should be rare, except for transfers due to the changes in circumstances that were discussed above. Transfers from the held-to-maturity account not meeting the exceptions indicated above may call into question management's intent to hold other securities to maturity. According to the standard, transfers into or from the trading category should also be rare.

FASB 115 requires that institutions determine whether a decline in fair value below the amortized cost for individual securities in the available-for-sale or held-to-maturity accounts

23. In summary, under FASB 115, sales of debt securities that meet either of the following two conditions may be considered as "maturities" for purposes of the balance-sheet classification of securities: (i) The sale of a security occurs near enough to its maturity date (or call date if exercise of the call is probable)—for example, within three months—that interest-rate risk has been substantially eliminated as a pricing factor. (ii) The sale of a security occurs after the institution has already collected at least 85 percent of the principal outstanding at acquisition from either prepayments or scheduled payments.

is "other than temporary" (that is, whether this decline results from permanent impairment). For example, if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security that was not impaired at acquisition, an other-than-temporary impairment should be considered to have occurred. If the decline in fair value is judged to be other than temporary, the cost basis of the individual security should be written down to its fair value, and the write-down should be accounted in earnings as a realized loss. This new cost basis should not be written up if there are any subsequent recoveries in fair value.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Securities and Derivatives

Investing in Securities without Reliance on Ratings of Nationally Recognized Statistical Rating Organizations

Effective date April 2013

Section 2510.1

On November 15, 2012, state member banks were advised, effective January 1, 2013, that they may no longer rely solely on credit ratings issued by nationally recognized statistical rating organizations (NRSROs) or external credit ratings to determine whether a particular security is an ''investment security'' that is permissible for investment by a state member bank. Under the regulations of the Office of the Comptroller of the Currency (OCC), securities qualify for investment by national banks only if they are determined by the bank to be ''investment grade'' and not predominantly speculative in nature. (See SR-12-15 and its attachment.) The basic sound risk-management principles of this policy and other referenced guidance that follows also applies to bank holding companies (BHCs) and savings and loan holding companies (SLHCs). They should manage and control their risk exposures on a consolidated basis and give recognition to the legal distinctions and potential obstacles to the cash movements among their financial institution subsidiaries. Since a BHC's structure can include national banks, state member banks, and other financial institution subsidiaries, the referenced statutory, regulatory, and supervisory guidance is provided.

Under the Federal Reserve Act (12 USC 335) and the Federal Reserve (FR)'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)). Therefore, when investing in securities, state member banks must comply with the provisions of the National Banking Act and the OCC's regulations in 12 CFR part 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.

National banks are to assess a security's creditworthiness to determine if it is ''investment grade.'' A security meets the ''investment grade'' test only if the issuer has an adequate capacity to meet its financial commitments under the security for the projected life of the asset or exposure. Under this definition, 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.[1] National banks are expected to consider a number of factors, to the extent appropriate in making this determination. While a national bank may continue to take into account external credit ratings and assessments as a valuable source of information, the bank 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.[2]

The OCC issued guidance, effective January 1, 2013 (OCC investment guidance), to clarify regulatory expectations with respect to investment purchase decisions and ongoing portfolio due diligence processes. See appendix 1 below. The guidance clarifies that generally, investment securities are expected to have good to very strong credit quality. In the case of structured securities, this determination may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

The OCC also expects national banks to conduct an appropriate level of due diligence to understand the inherent risks of a security and determine that it is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the ''investment-grade'' standards. The depth of the due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment. Third-party analytics may be part of this analysis, although the national bank's management remains responsible for the investment decision and should ensure that prospective third parties are independent, reliable, and qualified. The guidance also sets forth an expectation that the board of directors should oversee management to make sure appropriate decisionmaking processes are in place.[3]

Investment in securities and stock by state member banks are required under the Federal Reserve Act and Regulation H to comply with the revised 12 CFR part 1 and should meet the supervisory expectations set forth in the OCC's

1. See 77 *Fed. Reg.* 35257 (June 13, 2012).
2. See 77 *Fed. Reg.* 35254 (June 13, 2012).
3. See 77 *Fed. Reg.* 35259 (June 13, 2012).

investment guidance and this FR guidance. In addition, state member banks are expected to continue to meet long-established supervisory expectations for risk-management processes to ensure that the credit risk of the bank, including the credit risk of the investment portfolio, is effectively identified, measured, monitored, and controlled.

APPENDIX 1—OCC GUIDANCE ON DUE DILIGENCE REQUIREMENTS IN DETERMINING WHETHER SECURITIES ARE ELIGIBLE FOR INVESTMENT

The guidance below was issued by the Office of the Comptroller of the Currency (OCC) on June 13, 2012, and is being included for ease of reference. The official guidance was published in the Federal Register (77 Fed. Reg. 35259), and is available as an attachment to OCC Bulletin 2012-18. As discussed in SR-12-15, the Federal Reserve also expects that state member banks (SMBs) will meet the supervisory expectations set forth in the OCC guidance as this guidance provides further clarification to the OCC rule with which SMBs must comply. (See 12 CFR part 1, and 77 Fed. Reg. 35253, June 13, 2012.)

Purpose

The OCC has issued final rules to revise the definition of ''investment grade,'' as that term is used in 12 CFR parts 1 and 160 in order to comply with section 939A of the Dodd-Frank Act. Institutions, effective January 1, 2013, are to ensure that existing investments comply with the revised ''investment grade'' standard, as applicable based on investment type, and safety and soundness practices described in 12 CFR 1.5 and this guidance. This implementation period also will provide management with time to evaluate and amend existing policies and practices to ensure new purchases comply with the final rules and guidance. National banks that have established due diligence review processes, and that have not relied exclusively on external credit ratings, should not have difficulty establishing compliance with the new standard.

The OCC is issuing this guidance (Guidance) to clarify steps national banks ordinarily are expected to take to demonstrate they have properly verified their investments meet the newly established credit-quality standards under 12 CFR part 1 and steps national banks are expected to take to demonstrate they are in compliance with due diligence requirements when purchasing investment securities and conducting ongoing reviews of their investment portfolios. The standards below describe how national banks may purchase, sell, deal in, underwrite, and hold securities consistent with the authority contained in 12 USC 24 (Seventh). The activities of national banks must be consistent with safe and sound banking practices, and this Guidance reminds national banks of the supervisory risk-management expectations associated with permissible investment portfolio holdings under parts 1 and 160.

Background

Parts 1 and 160 provide standards for determining whether securities have appropriate credit quality and marketability characteristics to be purchased and held by national banks. These requirements also establish limits on the amount of investment securities an institution may hold for its own account. As defined in 12 CFR part 1, an ''investment security'' must be ''investment grade.'' For the purpose of part 1, ''investment grade'' securities are those where the issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment. An issuer has an adequate capacity to meet financial commitments if the risk of default by the obligor is low and the full and timely repayment of principal and interest is expected. Generally, securities with good to very strong credit quality will meet this standard. In the case of a structured security (that is, a security that relies primarily on the cash flows and performance of underlying collateral for repayment, rather than the credit of the entity that is the issuer), the determination that full and timely repayment of principal and interest is expected may be influenced more by the quality of the underlying collateral, the cash flow rules, and the structure of the security itself than by the condition of the issuer.

National banks must be able to demonstrate that their investment securities meet applicable credit-quality standards. This Guidance provides criteria that national banks can use in meeting part 1 credit-quality standards and that national banks can use in meeting due diligence requirements.

Determining Whether Securities Are Permissible Prior to Purchase

The OCC's elimination of references to credit ratings in its regulations, in accordance with the Dodd-Frank Act, does not substantively change the standards institutions should use when deciding whether securities are eligible for purchase under part 1. The OCC's investment securities regulations generally require a national bank to determine whether or not a security is "investment grade" in order to determine whether purchasing the security is permissible. Investments are considered "investment grade" if they meet the regulatory standard for credit quality. To meet this standard, a national bank must be able to determine that the security has (1) low risk of default by the obligor and (2) the expectation of full and timely repayment of principal and interest over the expected life of the investment.

For national banks, Type I securities, as defined in part 1, generally are government obligations and are not subject to investment grade criteria for determining eligibility to purchase. Typical Type I obligations include U.S. Treasuries, agencies, municipal government general obligations, and for well-capitalized institutions, municipal revenue bonds. While Type I obligations do not have to meet the investment grade criteria to be eligible for purchase, all investment activities should comply with safe and sound banking practices as stated in 12 CFR 1.5 and in previous regulatory guidance. Under OCC rules, Treasury and agency obligations do not require individual credit analysis, but bank management should consider how those securities fit into the overall purpose, plans, and risk and concentration limitations of the investment policies established by the board of directors. Municipal bonds should be subject to an initial credit assessment and then ongoing review consistent with the risk characteristics of the bonds and the overall risk of the portfolio.

Financial institutions should be well acquainted with fundamental credit analysis, as this is central to a well-managed loan portfolio. The foundation of a fundamental credit analysis-character, capacity, collateral, and covenants-applies to investment securities just as it does to the loan portfolio. Accordingly, the OCC expects national banks to conduct an appropriate level of due diligence to understand the inherent risks and determine that a security is a permissible investment. The extent of the due diligence should be sufficient to support the institution's conclusion that a security meets the investment grade standards. This may include consideration of internal analyses, third party research and analytics including external credit ratings, internal risk ratings, default statistics, and other sources of information as appropriate for the particular security. Some institutions may have the resources to do most or all of the analytical work internally. Some, however, may choose to rely on third parties for much of the analytical work. While analytical support may be delegated to third parties, management may not delegate its responsibility for decisionmaking and should ensure that prospective third parties are independent, reliable, and qualified. The board of directors should oversee management to assure that an appropriate decisionmaking process is in place.

The depth of the due diligence should be a function of the security's credit quality, the complexity of the structure, and the size of the investment. The more complex a security's structure, the more credit-related due diligence an institution should perform, even when the credit quality is perceived to be very high. Management should ensure it understands the security's structure and how the security may perform in different default environments, and should be particularly diligent when purchasing structured securities.[4] The OCC expects national banks to consider a variety of factors relevant to the particular security when determining whether a security is a permissible and sound investment. The range and type of specific factors an institution should consider will vary depending on the particular type and nature of the securities. As a general matter, a national bank will have a greater burden to support its determination if one factor is contradicted by a finding under another factor.

The following matrix provides examples of factors for national banks to consider as part of

4. For example, a national bank should be able to demonstrate an understanding of the effects on cash flows of a structured security assuming varying default levels in the underlying assets.

a robust credit-risk assessment framework for designated types of instruments. The types of securities included in the matrix require a credit-focused pre-purchase analysis to meet the investment grade standard or safety and soundness standards. Again, the matrix is provided as a guide to better inform the credit-risk assessment process. Individual purchases may require more or less analysis dependent on the security's risk characteristics, as previously described.

Key factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities
Confirm spread to U.S. Treasuries is consistent with bonds of similar credit quality	X	X	X	X
Confirm risk of default is low and consistent with bonds of similar credit quality	X	X	X	X
Confirm capacity to pay and assess operating and financial performance levels and trends through internal credit analysis and/or other third party analytics, as appropriate for the particular security	X	X	X	X
Evaluate the soundness of a municipal's budgetary position and stability of its tax revenues. Consider debt profile and level of unfunded liabilities, diversity of revenue sources, taxing authority, and management experience		X		
Understand local demographics/economics. Consider unemployment data, local employers, income indices, and home values		X	X	
Assess the source and strength of revenue structure for municipal authorities. Consider obligor's financial condition and reserve levels, annual debt service and debt coverage ratio, credit enhancement, legal covenants, and nature of project			X	
Understand the class or tranche and its relative position in the securitization structure				X
Assess the position in the cash flow waterfall				X
Understand loss allocation rules, specific definition of default, the potential impact of performance and market value triggers, and support provided by credit and/or liquidity enhancements				X
Evaluate and understand the quality of the underwriting of the underlying collateral as well as any risk concentrations				X
Determine whether current underwriting is consistent with the original underwriting underlying the historical performance of the collateral and consider the effect of any changes				X

Key factors	Corporate bonds	Municipal government general obligations	Revenue bonds	Structured securities
Assess the structural subordination and determine if adequate given current underwriting standards				X
Analyze and understand the impact of collateral deterioration on tranche performance and potential credit losses under adverse economic conditions				X

Additional Guidance on Structured Securities Analysis

The creditworthiness assessment for an investment security that relies on the cash flows and collateral of the underlying assets for repayment (i.e., a structured security) is inherently different from a security that relies on the financial capacity of the issuer for repayment. Therefore, a financial institution should demonstrate an understanding of the features of a structured security that would materially affect its performance and that its risk of loss is low even under adverse economic conditions. Management's assessment of key factors, such as those provided in this guidance, will be considered a critical component of any structured security evaluation. Existing OCC guidance, including OCC Bulletin 2002-19, "Supplemental Guidance, Unsafe and Unsound Investment Portfolio Practices," states that it is unsafe and unsound to purchase a complex high-yield security without an understanding of the security's structure and performing a scenario analysis that evaluates how the security will perform in different default environments. Policies that specifically permit this type of investment should establish appropriate limits, and prepurchase due diligence processes should consider the impact of such purchases on capital and earnings under a variety of possible scenarios. The OCC expects institutions to understand the effect economic stresses may have on an investment's cash flows. Various factors can be used to define the stress scenarios. For example, an institution could evaluate the potential impact of changes in economic growth, stock market movements, unemployment, and home values on default and recovery rates. Some institutions have the resources to perform this type of analytical work internally. Generally, analyses of the application of various stress scenarios to a structured security's cash flow are widely available from third parties. Many of these analyses evaluate the performance of the security in a base case and a moderate and severe stress case environment. Even under severe stress conditions, the stress scenario analysis should determine that the risk of loss is low and full and timely repayment of principal and interest is expected.

Maintaining an Appropriate and Effective Portfolio Risk-Management Framework

The OCC has had a long-standing expectation that national banks implement a risk-management process to ensure credit risk, including credit risk in the investment portfolio, is effectively identified, measured, monitored, and controlled. The *1998 Interagency Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities* (Policy Statement) contains risk-management standards for the investment activities of banks and savings associations.[5] The Policy Statement emphasizes the importance of establishing and maintaining risk processes to manage the market, credit, liquidity, legal, operational, and other risks of investment securities. Other previously issued guidance that supplements OCC investment standards are OCC 2009-15, "Risk Management and Lessons Learned" (which highlights lessons learned during the market disruption and re-emphasizes the key principles discussed in previously issued OCC guidance on portfolio risk management); OCC 2004-25, "Uniform Agreement on the Classification of Securities" (which describes

5. On April 23, 1998, the FRB, FDIC, NCUA, and OCC issued the "Supervisory Policy Statement on Investment Securities and End-User Derivatives Activities."

the importance of management's credit-risk analysis and its use in examiner decisions concerning investment security risk ratings and classifications); and OCC 2002-19, "Supplemental Guidance, Unsafe and Unsound Investment Portfolio Practices" (which alerts banks to the potential risk to future earnings and capital from poor investment decisions made during periods of low levels of interest rates and emphasizes the importance of maintaining prudent credit, interest rate, and liquidity risk-management practices to control risk in the investment portfolio).

National banks must have in place an appropriate risk-management framework for the level of risk in their investment portfolios. Failure to maintain an adequate investment portfolio risk-management process, which includes understanding key portfolio risks, is considered an unsafe and unsound practice.

Having a strong and robust risk-management framework appropriate for the level of risk in an institution's investment portfolio is particularly critical for managing portfolio credit risk. A key role for management in the oversight process is to translate the board of directors' tolerance for risk into a set of internal operating policies and procedures that govern the institution's investment activities. Policies should be consistent with the organization's broader business strategies, capital adequacy, technical expertise, and risk tolerance. Institutions should ensure that they identify and measure the risks associated with individual transactions prior to acquisition and periodically after purchase. This can be done at the institutional, portfolio, or individual instrument level. Investment policies also should provide credit-risk concentration limits. Such limits may apply to concentrations relating to a single or related issuer, a geographical area, and obligations with similar characteristics. Safety-and-soundness principles warrant effective concentration risk-management programs to ensure that credit exposures do not reach an excessive level.

The aforementioned risk-management policies, principles, and due diligence processes should be commensurate with the complexity of the investment portfolio and the materiality of the portfolio to the financial performance and capital position of the institution. Investment review processes, following the pre-purchase analysis, may vary from institution to institution based on the individual characteristics of the portfolio, the nature and level of risk involved, and how that risk fits into the overall risk profile and operation of the institution. Investment portfolio reviews may be risk-based and focus on material positions or specific groups of investments or stratifications to enable analysis and review of similar risk positions.

As with pre-purchase analytics, some institutions may have the resources necessary to do most or all of their portfolio reviews internally. However, some may choose to rely on third parties for much of the analytical work. Third-party vendors offer risk analysis and data benchmarks that could be periodically reviewed against existing portfolio holdings to assess credit-quality changes over time. Holdings where current financial information or other key analytical data is unavailable should warrant more frequent analysis. High-quality investments generally will not require the same level of review as investments further down the credit-quality spectrum. However, any material positions or concentrations should be identified and assessed in more depth and more frequently, and any system should ensure an accurate and timely risk assessment and reporting process that informs the board of material changes to the risk profile and prompts action when needed. National banks should have investment portfolio review processes that effectively assess and manage the risks in the portfolio and ensure compliance with policies and risk limits. Institutions should reference existing regulatory guidance for additional supervisory expectations for investment portfolio risk-management practices.

LAWS, REGULATIONS, INTERPRETATIONS, AND ORDERS

Subject	*Laws*[1]	*Regulations*[2]	*Interpretations*[3]	*Orders*
State member banks are subject to same limitations and conditions for investments activities as national banks	24 (Seventh), 335	1, 208.21		
Federal financial institution regulatory agencies to remove references to, and requirements of reliance on, external credit ratings in any regulation that requires the assessment of the creditworthiness of a security or money market instrument.	15 USC 780			
Supervisory and risk expectations		1, 160		
Safety and soundness practices		1.5		

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

INTRODUCTION

The Securities Act of 1933 requires that adequate and reliable information be made available about securities originally offered for sale to the public. The act requires registration of any securities sale with the Securities and Exchange Commission (SEC) unless it is specifically exempted. Section 4(2) of the act exempts "transactions by an issuer not involving any public offering" (referred to as a "private placement"). A private placement, also known as an unregistered offering, raises capital through the sale of securities to a single, or small number of, select investors.

Common participants in arranging a private placement include banks, mutual funds, insurance companies, pension funds, and hedge funds. The matching of a security issuer with investors is usually done by an individual, or firm, acting as either an agent or an adviser. In the agent relationship, the firm has authority to commit the security issuer. An adviser has no such power. Agents, usually investment bankers, participate in negotiations between the security issuer and investors, and their fee is dependent on their involvement. Agreements between the firm and all other parties to the transaction should specifically state with whom the firm is representing as an agent.

Regardless of whether the firm is agent or adviser, the firm should be aware of the SEC's Regulation D, "Rules Governing the Limited Offer and Sale of Securities Without Registration Under the Securities Act of 1933," (17 CFR 230.500). While the bank does not have to register private placement investments with the SEC, bank policies should address measures to comply with relevant SEC regulations, including Regulation D, which exempts certain transactions from the registration requirements of section 5 of the Securities Act of 1933.[1] Regulation D states

> Such transactions are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws. Issuers are reminded of their obligation to provide such further material information, if any, as may be necessary to make the information required under Regulation D, in light of the circumstances under which it is furnished, not misleading.[2]

In addition, a bank's private placements policy should address any applicable state laws relating to the offer and sale of securities.

PRIVATE-PLACEMENT ACTIVITIES BY BANKS

Private placements have certain advantages and disadvantages for both investors and issuers. Compared to public offerings, private placements have fewer regulatory requirements. While private placements raise capital through the sale of securities, the issuer does not have to register the investment with the SEC. Therefore, the time and expense of registering a security with the SEC does not apply to private placements.

In a private placement, both investor and issuer can complete the transaction without being subject to regulatory and public scrutiny. Further, the process of underwriting the private placement is generally faster than a public offering, which allows the issuer to receive proceeds from the sale in less time. If an issuer is selling a bond, the issuer can bypass the expenses associated with obtaining a credit rating from a rating agency. Private placements are flexible, and investments can be tailored to meet the specific needs of the relevant parties. For example, an investor can make an investment for a specified length of time at a stated rate of return.

The major disadvantage of private placements to the investor is the general lack of a secondary market. Thus, the investor may be unable to liquidate the holding until maturity. Additionally, unlike registered offerings in which certain information is required to be disclosed, investors in private placements are generally on their own in obtaining the information they need to make an informed investment decision. Further, the SEC does not review private placements. For instance, a private placement does not require a prospectus and, in some cases, detailed financial information is not disclosed. Instead of a prospectus, a private placement memorandum can accompany a private placement. In general, the private placement memorandum is not publicly

1. 15 U.S.C. 77a et seq., as amended.

2. 17 CFR 230.500(a).

marketed. Given this lack of transparency in the private placement memorandum, investors need to recognize that the memo may not completely describe the investment and related risks. Therefore, investors need to fully understand the terms and risks of the investment. Thus, potential investors should perform their own risk assessment and request additional information as part of their pre-purchase due diligence.

There are also disadvantages to the issuer. A private placement may limit the amount of capital that may be raised since the number of potential investors is usually very small. Moreover, advisory and legal fees may also be high relative to the size of the issue.

In addition to investing in private placement securities, banks may also offer private placement services in either an agent or adviser capacity. In the "agent" relationship, the bank has authority to commit the issuer. Agents participate in negotiations between issuers and potential investors and assist in the actual placement of securities sold by the issuer. The agents often collect a fee based on a percentage of the securities placed. In contrast, in an "adviser" capacity, the bank does not have authority to commit the issuer. In general, advisers do not assist in the actual sale of the securities, their role being limited to advising the issuer on the structure and terms of the placement transaction.

RISK MANAGEMENT OF PRIVATE PLACEMENTS

A bank that offers private-placement services should establish risk management policies and procedures that address the types of risks arising from private placements. Like any other banking activity or function, a bank's board of directors has the responsibility for establishing the level of risk that the bank should take in engaging in private placements. Accordingly, the board of directors should approve the bank's overall business strategies and significant policies, including those related to managing risks. In turn, senior management is responsible for implementing strategies set by the board of directors in a manner that controls risks and that complies with statutes, and regulations on both a long-term and day-to-day basis. Once the risks are properly identified, the bank's policies and procedures should provide guidance on the day-to-day implementation of business strategies for private placement activity, including limits designed to prevent excessive and imprudent risks.

A bank's policy on private placements should cover the establishment of procedures, processes, and controls to mitigate fraudulent activities, self-dealing practices, or conflicts-of-interest. For example, a bank acting as adviser or agent assumes the risk of a potential conflict-of-interest charge whenever the proceeds from the placement are used to reduce a classified loan at the bank. Under this scenario, the bank should disclose relevant information about its business dealings with the issuer and financial condition of the issuer, especially if the issuer is borrowing from the bank and is experiencing financial difficulty. Although the bank may not commit funds in a private-placement transaction, the potential for financial loss or damage to its reputation does exist if the bank does not prudently deal with all parties to the transaction and fairly disclose all relevant information.

Banks engaged in private placement activities should establish procedures for conducting prudent pre-purchase analysis of securities. More information on conducting appropriate due diligence and pre-purchase analysis for investments to meet credit quality standards under 12 CFR part 1 are found in SR-12-15, "Investing in Securities without Reliance on Nationally Recognized Statistical Rating Organization Ratings."[3] Banks should develop procedures to provide timely ongoing monitoring of private-placement activities. Moreover, procedures should be established to detect any transactions that could have an adverse effect on the bank's other functions, such as loan or trust department activities.

SUPERVISORY CONSIDERATIONS

Examiners should understand the bank's involvement in private placement activities, determin-

3. Under the Federal Reserve Act (12 U.S.C. 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 U.S.C. 24 (Seventh)). When investing in securities, state member banks must comply with the provisions of the National Banking Act and the Office of the Comptroller of the Currency 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.

ing whether the bank acts as an investor, agent, or adviser. During the examination process, examiners should review and assess the adequacy of the bank's policies, practices, and procedures to manage private-placement activities. In reviewing the bank's private placement activities, examiners should assess bank staff's knowledge and expertise in this area. Examiners should also assess the bank's ability to comply with applicable statutes and regulations. In addition, examiners should determine whether the bank has incurred significant losses or has significant risk exposure as a result of participating in private placement activities.

1. To determine whether policies, procedures, and internal controls for private placement activities are appropriate.
2. To determine whether bank management implements the bank's policies and procedures.
3. To assess the adequacy of the bank's policies and procedures for pre-purchase and ongoing analysis of private placement activities.
4. To evaluate the overall effectiveness and quality of bank management in advising and completing private placements in compliance with statutes and regulations.
5. To initiate corrective action if policies, practices, procedures, or internal controls are deficient.

PRELIMINARY REVIEW

1. Based upon the evaluation of investment volume in private placements, or agent and advisory services, determine the scope of the examination.
2. Review prior examination reports, pre-examination memorandum, and file correspondence for an overview of any previously identified deficiencies.
3. Obtain a listing of any deficiencies noted in the latest review done by internal auditor, external auditors, other third parties, or regulators, and determine if corrections have been accomplished.
4. Obtain and review the following information from appropriate bank staff:
   - a list of the staff performing private placement agent or advisory services and their previous experience.
   - a list of investors that the bank normally deals with in placing private offerings and their stated investment requirements.
   - a copy of the bank's standard form agreements used in private placement transactions.
   - a list of private placements invested in, or served as agent or adviser for, by the bank since the last examination. Additional information includes
     — name of issuer;
     — name of investor(s), including banks;
     — fee and how it was determined; and
     — amount, rate, and maturity of issue.
   - a list of any funds managed by the bank or its trust department, subsidiaries or affiliates that have been used to purchase private placements advised by the bank or an affiliate.
   - a list of any borrowers whose loans were partially or fully repaid from the sale of private placements advised by the bank since the last examination.
   - a list of participations purchased or sold in loans that used funds from private placements advised by the bank.
5. Review the pertinent information obtained from the previous procedure and compare the information to the list of classified assets from the previous examination.
6. Review and assess the adequacy of applicable policies and procedures for private placement activities. Consider whether the policies and procedures
   - define objectives;
   - provide guidelines for fee determinations based on size and complexity of the transaction;
   - discuss payment of negotiated fees at various stages of the transaction;
   - define the capacity in which bank officers can act in negotiations (Note: An adviser will advise and assist a client, an agent has the authority to commit a client.)
   - recognize possible conflicts of interest and establish appropriate procedures regarding
     — the purchase of bank-advised private placements with funds managed by the bank or an advisory affiliate;
     — loans to investors to purchase private placements;
     — use of proceeds of an advised placement to repay the issuer's debts to the bank; and
     — dealings with unsophisticated investors who have other business relationships with the bank;
   - discuss bank management's level of review of each placement prior to completion;
   - direct officers to obtain certified financial statements from the seller and require distribution of certified financial statements to interested investors;
   - require officers to request a written statement of investment objectives or requirements from interested investors;
   - outline the need for management review to determine whether a placement is suitable for the investor; and
   - include appropriate pre-purchase and ongoing analysis of private placement securities purchased.
7. Assess the adequacy of pre-purchase and ongoing analysis conducted on private placement securities purchased.
8. Distribute the list of placements to the examiner assigned loan portfolio manage-

ment to determine whether any loans were made to fund the investment in the private placement.

9. Review files related to a representative sample of all placement transactions and determine if the bank evaluates both the issuer and investor in a private placement transaction, including the suitability of the investment to the stated investment requirements of the investor.
10. Determine whether potential conflicts of interest exist between bank-advised placements and interests of directors and principal officers. Consider whether former banking relationships exist for both issuer and investor and whether fees charged for loans or paid on deposits are within normal bank policy.
11. As appropriate, discuss with bank management and prepare summaries in appropriate report form of
    - deficiencies in policies, practices, and internal controls.
    - any placement activities that do not comply with statutes and regulations or compromise the bank's safety and soundness.
    - recommended corrective action.
12. Update examination work papers with any information that will facilitate future examinations.

3000—CAPITAL, EARNINGS, LIQUIDITY, AND SENSITIVITY TO MARKET RISK

The 3000 series of sections address the supervisory assessment of a state member bank's **C**apital, **E**arnings, **L**iquidity, and **S**ensitivity to market risk (CELS). In addition to the review of asset quality (see the 2000 series major heading), the CELS components represent the key areas that examiners review in assessing the overall financial condition of the bank.

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 depositor 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.[1] 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,[2] or
- 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, "Frequently Asked Questions on the Regulatory Capital Rule" and the "New Capital Rule: Community Bank Guide" (July 2013).

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 noncumulative 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),[3] or adjusted allowances for credit losses (AACL),[4] as applicable, less applicable regula-

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-

tory 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 nonbank 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.

ties. For more information on CECL, see this manual's section "Allowance for Credit Losses."

- *High volatility commercial real estate loans (HVCRE).*[5] 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 organiza-

5. Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), Pub. L. No. 115-174, 132 Stat. 1296, 1321–22 (2018), addressed the treatment of HVCRE by adding section 51 to the Federal Deposit Insurance Act (FDIA), 12 U.S.C. 1831bb. FDIA section 51 provides a statutory definition of high volatility commercial real estate acquisition, development, or construction (HVCRE ADC) loans. Under FDIA section 51, the agencies may only require a depository institution to assign a heightened risk weight to a HVCRE exposure, as defined under the capital rule, if such exposure is an HVCRE ADC loan. This statutory change was effective upon enactment of EGRRCPA in May 2018. The agencies also amended their capital rules to reflect this statutory change. See 84 Fed. Reg. 68,019 (December 13, 2019).

tions. 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 the fund 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 type 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 resecuritization 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(c)): (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

Category	*Risk weight*	*Section of the rule (12 CFR 217)*
Cash	0%	217.32(1)(1)
Direct and unconditional claims on the U.S. government, its agencies, and the Federal Reserve	0%	217.32(a)(1)(i)
Claims on certain supranational entities and multilateral development banks	0%	217.32(b)
Cash items in the process of collection	20%	217.32
Conditional claims on the U.S. government	20%	217.32(a)(1)(ii)
Claims on government-sponsored enterprises (GSEs)	20% on exposures other than equity exposures and preferred stock. 100% on GSE preferred stock.	217.32(c)
Claims on U.S. depository institutions and National Credit Union Administration-insured credit unions	20% 100% risk weight for an investment in an instrument included in another banking organization's regulatory capital unless the instrument is an equity exposure or required to be deducted.	217.32(d)(1) and (3)
Claims on U.S. public sector entities	20% for general obligations. 50% for revenue obligations.	217.32(e)(1)
Industrial development bonds	100%	217.32(l)(5)
Claims on qualifying securities firms	100% – See corporate exposures below.	217.32(f)
One- to four-family loans	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.	217.32(g)
One- to four-family loans modified under Home Affordable Modification Program	50% and 100% The banking organization must use the same risk weight assigned to the loan prior to the modification so long as the loan continues to meet other applicable prudential criteria.	217.32(g)(3)

Category	*Risk weight*	*Section of the rule (12 CFR 217)*
Loans to builders secured by one- to four-family properties presold under firm contracts	50% if the loan meets all criteria in the regulation. 100% if the contract is cancelled. 100% for loans not meeting the criteria.	217.32(h)
Loans on multifamily properties	50% if the loan meets all the criteria in the regulation for a statutory multifamily property; 100% otherwise.	217.32(i)
Corporate exposures and consumer loans	100% unless the exposure is an investment in an instrument included in the regulatory capital of another financial institution.	217.32(f)
Commercial real estate (CRE)	100% 150% for high volatility commercial real estate, which is, subject to certain exceptions, a credit facility secured by land or improved real property that primarily finances has financed, or refinances the acquisition, development, or construction of real property; has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility.	217.32(j) and (*l*)(5)
Past-due exposures	150% for the portion that is not guaranteed or secured (does not apply to sovereign exposures). However, one- to four-family loans that are past due 90 days or more are assigned a 100% risk weight.	217.32(k)
Assets not assigned to a risk weight category, including fixed assets, premises, and other real estate owned	100%	217.32(*l*)(5)
Mortgage-backed securities, asset-backed securities, and structured securities	Two general approaches—gross-up approach and simple supervisory formula approach. May also choose to risk weight a securitization exposure at 1,250%.	217.42, .43, and .44

Category	*Risk weight*	*Section of the rule (12 CFR 217)*
Equity exposures	Range of risk weights between 0% and 600%, depending on the entity and whether the equity is publicly traded	217.51 and .52
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.	217.53
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.	217.32(a)(2) to (6), (d)(2) and (e)(2) to (6)

Advanced Approaches

The advanced approaches framework[6] 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

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]

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.
10. See 84 Fed. Reg. 61,797 (November 13, 2019) and 12 CFR 217.12.
11. From April 23, 2020, through December 31, 2021, a lower leverage ratio criterion applies. See 12 CFR 217.304.
12. For more detailed information on the applicability of

TABLE 2—CAPITAL RATIO CALCULATIONS AND MINIMUM RATIOS

Ratio	Calculation	Minimum
Common equity tier 1 capital ratio	$\frac{\text{common equity tier 1 capital}}{\text{standardized total risk-weighted assets}}$	4.5%
Tier 1 capital ratio	$\frac{\text{tier 1 capital}}{\text{standardized total risk-weighted assets}}$	6%
Total capital ratio	$\frac{\text{total capital}}{\text{standardized total risk-weighted assets}}$	8%
Leverage ratio	$\frac{\text{tier 1 capital}}{\text{average total consolidated assets}}$	4%

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.[13]

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:

$$\frac{\text{Tier 1 capital}}{\text{Average total consolidated assets}}$$

The calculation of a Board-regulated institution's leverage ratio is described in the generally applicable requirement.[14] 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.[15] 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

the CBLR framework, see 12 CFR 217.12(a)(2).

13. See FDIA section 38, 12 U.S.C. 1831o, and the Board's Regulation H, 12 CFR part 208.

14. 12 CFR 217.10.

15. From April 23, 2020, through December 31, 2021, lower grace period thresholds apply. See 12 CFR 217.304.

capitalized" ratio requirements and to be in 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

16. From April 23, 2020, through December 31, 2021, lower grace period thresholds apply. See 12 CFR 217.304.
17. 12 CFR 217.10(a)(5) and (c)(4).
18. 85 Fed. Reg. 4569 (January 27, 2020).
19. 80 Fed. Reg. 49,082 (August 14, 2015).

8 percent for the first three years of its existence.[20] 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.[21] 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 jurisdictions. 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

20. Refer to 12 CFR 217.10(a). This expectation does not prevent a de novo that is a qualifying community banking organization from electing to be subject to the community bank leverage ratio framework. See also 12 CFR 217.12.

21. 85 Fed. Reg. 15,576 (March 18, 2020).

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, supplementary 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," "undercapitalized," "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.[22] 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 raises supervisory concerns when an institution is experiencing 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).

weaknesses, or has other serious problems or inadequate capital:

- the payment of dividends not covered by earnings,
- 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.[23]

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.[24]

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.[25] 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 he adequacy of the bank's allowance for loan and lease losses or adjusted allowance for credit losses.

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*.

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 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 AACL 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 AACL 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 AACL 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.

Stress Testing and Capital Adequacy

Stress testing is a tool that helps both bank supervisors and certain firms measure the sufficiency of capital available to support the firm's operations throughout periods of stress. The Federal Reserve and the other federal banking agencies have highlighted the use of stress testing as a means to better understand the range of a financial company's potential risk exposures. While stress tests are a valuable tool for assessing the capital adequacy of a firm, stress tests may not necessarily capture a company's full range of risks, exposures, activities, and vulnerabilities that have a potential effect on capital adequacy.

The Federal Reserve has established frameworks and programs for the supervision of its largest and most complex financial institutions to achieve its supervisory objectives, incorporating lessons learned from the 2008–09 financial crisis and in the period since. As part of these supervisory frameworks and programs, the Federal Reserve assesses whether bank holding companies with $100 billion or more in total consolidated assets and U.S. intermediate holding companies are sufficiently capitalized to absorb losses during stressful conditions while meeting obligations to creditors and counterparties and continuing to be able to lend to households and businesses. On October 10, 2019, the Federal Reserve amended its prudential standards to exempt firms with total consolidated assets of less than $100 billion from the supervisory stress test and to subject certain firms with total consolidated assets between $100 billion and $250 billion to the supervisory stress test requirements on a two-year cycle.[26] Bank holding companies and intermediate holding companies with $250 billion or more in total consolidated assets or material levels of other risk factors remain subject to the supervisory stress test requirements on an annual basis.

RATING THE CAPITAL FACTOR FOR STATE MEMBER BANKS

As stated in the Uniform Financial Institutions Rating System[27] 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.

26. 84 Fed. Reg. 59,032 (November 1, 2019).
27. 61 Fed. Reg. 67,021 (December 19, 1996).

- Access to capital markets and other sources of capital, including support provided by a parent holding company.

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.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Capital

Dividends are distributions of earnings to owners.[1] 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.[2] 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.

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.

Table 1—Calculation of Maximum Payout Amount

Capital Conservation Buffer (as a percentage of risk weighted assets)	Maximum Payout Ratio (as a percentage of the previous four quarters of net income)
Greater than 2.5%	No payout ratio limitation applies.
Less than or equal to 2.5% and greater than 1.875%	60%
Less than or equal to 1.875% and greater than 1.25%	40%
Less than or equal to 1.25% and greater than 0.625%	20%
Less than or equal to 0.625%	0%

STATUTORY LIMITATIONS

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 USC 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.[4] 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).[5] 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.

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.

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.

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.

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. Determine whether there is undue pressure to pay dividends. Items to consider include
   - the holding company's financial condition and contractual obligations,
   - the financial condition of affiliates,
   - stockholder or market pressure, and
   - capital distribution and bonus limitations under the capital conservation buffer.
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]

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.

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.

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

	Year			
	20__	*20__*	*20__*	*Total*
Net income (loss) (schedule RI, item 12)	___	___	___	___
Less: Required transfers to surplus under state law (generally zero) or transfers to a fund for the retirement of any preferred stock	___	___	___	___
Less: Common and preferred stock dividends declared (schedule RI-A, item 8 + item 9)	___	___	___	___
Retained net profits available for dividends before adjustments	___	___	___	___
Adjustments for dividends in excess of income (if any)[1]	___	___	___	___
Retained net profits available for dividends after adjustments	___	___	___	___[2]

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

	Year
	20__
Retained earnings (undivided profits) (schedule RC, item 26a)	_____
Add: Surplus in excess of state regulatory requirements that was earned and is transferred, with prior regulatory approval, back to undivided profits	_____
Less: Loan losses or other losses derived from extensions of credit that are in excess of the allowance for loan and lease losses	_____
Section 56 limitation	_____

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 overcollateralization, 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.

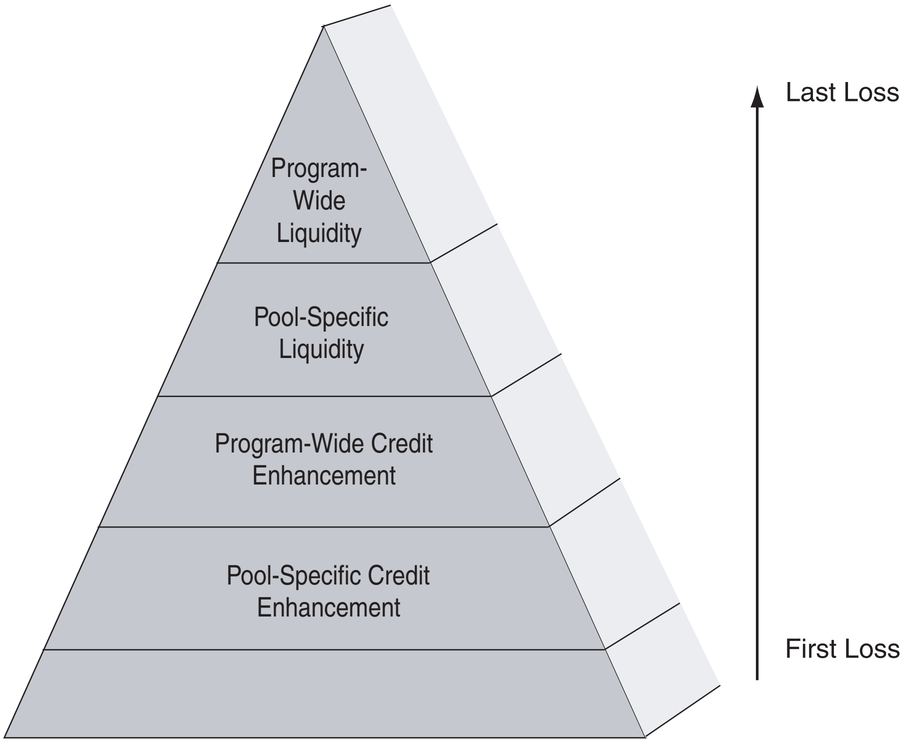
Commercial Paper Investors

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

The Loss Waterfall



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 structured (credit-enhanced) to achieve a credit-quality equivalent of investment grade (that is, BBB or higher). The sponsoring banking organization will typically utilize established rating agency criteria and structuring methodologies to achieve the desired internal rating level. In certain instances, such as when ABCP programs purchase 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.[1] Some older ABCP programs may have both pool-specific liquidity and program-wide liquidity coverage, while more-recent ABCP programs tend to utilize only pool-specific facilities. Typically, the seller-provided credit enhancement continues to provide credit protection on an asset pool that is purchased by a liquidity banking organization so that the institution is protected against credit losses that may arise due to subsequent deterioration of the pool.

Pool-specific liquidity, when drawn prior to the ABCP program's credit enhancements, is subject to the credit risk of the underlying asset pool. However, the liquidity facility does not provide direct credit enhancement to the commercial paper holders. Thus, the pool-specific liquidity facility generally is in an economic second-loss position after the seller-provided credit enhancements and prior to the program-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.[2] While the liquidity banking organization is exposed to the credit risk of the underlying asset pool, the risk is mitigated by the seller-provided credit enhancement and the asset-quality test.[3] At the time that the asset pool is put to the liquidity banking organization, the facility is usually fully drawn because the entire amount of the pool that qualifies under the asset-quality test is pur-

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. 1831*o*).

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] The rule includes a common equity tier 1 capital requirement, and specifies criteria that instruments must meet in order to be considered common equity tier 1 capital, additional tier 1 capital, or tier 2 capital.
- 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]

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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 risk-based 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."[3]

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 transmittal 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, and may be subject to certain discretionary 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,[4] 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.[5] 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.[6]
3. *Undercapitalized.* The bank has a total risk-based capital ratio that is less than 8.0 percent, 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.[7]
4. *Significantly undercapitalized.* The bank has a total risk-based capital ratio that is less than

period-end total consolidated total assets whenever necessary, on a case-by-case basis). The tangible equity ratio is defined as core capital elements plus cumulative perpetual preferred stock, net of all intangible assets except those amounts of mortgage servicing assets allowable in tier 1 capital. See the Assessment of Capital Adequacy section of this manual for more detailed information.

3. See 12 CFR 217.

4. Beginning on January 1, 2018, any bank that is a subsidiary of a global systemically important bank holding company (referred to as a "G-SIB") under the definition of "subsidiary" in 12 CFR 217.2 has a supplementary leverage ratio of 6.0 percent or greater.

5. 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.

6. 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.

7. 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.

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.[8]

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.[9] 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

8. 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).

9. See 12 CFR 208.43(c).

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 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.[10] 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).

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).

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.[11]
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.[12] 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 noti-

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).

fying the bank. Under the mandatory provisions, an undercapitalized bank

- must cease paying dividends.
- 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 rollover 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 rates 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

13. 12 U.S.C. 1831o(f)(3).
14. 12 U.S.C. 1831o(h)(3).
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.

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;
- 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

Capital Category	Total Risk-Based Capital (RBC) Measure	Tier 1 RBC Measure	Common Equity Tier 1 RBC Measure	Leverage Measure
Well Capitalized	10% or more and	8% or more and	6.5% or more and	5% or more* and
Adequately Capitalized	8% or more and	6% or more and	4.5% or more and	4% or more**
Under-capitalized	less than 8% or	less than 6% or	less than 4.5% or	less than 4%**
Significantly Under-capitalized	less than 6% or	less than 4% or	less than 3% or	less than 3%
Critically Under-capitalized	tangible equity to total assets ratio of 2% or less			

* 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.

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.

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.

INTRODUCTION

From a regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings is the initial safeguard against the risks that a bank incurs in the course of doing business, and represents a bank's first line of defense against capital depletion resulting from a decline in the value of its assets. This section is designed to provide a high-level overview for examiners in assessing a bank's earning through the use of analytical review techniques. Examiners need to remain cognizant of the inextricable links among capital, asset quality, earnings, liquidity, and market risk sensitivity.

GENERAL EXAMINATION APPROACH

As part of the off-site preparation for an on-site examination, examiners review and analyze a bank's financial condition. (See the manual sections entitled, "Examination Strategy and Risk-Focused Examinations" and "Federal Reserve System Bank Surveillance Program.") This analysis is meant to identify potential problem areas and to develop the examination scope so that proper staff levels and appropriate examination procedures can be used.

The analysis of earnings includes all bank operations and activities. When evaluating earnings, examiners should develop an understanding of the bank's core business activities. Core activities are those operations that are part of a bank's normal or continuing business. Examiners should understand a bank's composition of earnings and sustainability of the various earnings components. This would include balance-sheet composition, particularly the volume and type of earning assets and off-balance-sheet items, if applicable.

ANALYTICAL REVIEW

In performing the analytical review of a bank, examiners should use the most recent Uniform Bank Performance Report (UBPR) as well as the most recent financial statements and other related financial information that supports the source and trend in the bank's earnings. A well-performed analytical review provides examiners with an understanding of the bank's operations. An analytical review of bank earnings highlights matters of interest and potential problem situations which, examiners will need to address with the bank. In reviewing and assessing a bank's earning, examiners perform level and trend analysis of financial report data and ratios as well as reviewing other metrics. Analytical review is based on the assumption that period-to-period balances and ratios are free from significant error considering the procedures relating to income and expenses, and regulatory reports conducted by internal or external auditors. (See the manual section entitled, "Internal Control and Audit Function, Oversight, and Outsourcing," for a discussion of factors to consider in reviewing the audit work of others.)

Analytical Tools

The UBPR and the bank's financial statements are key sources of analysis for examination staff. Bank-prepared statements and supplemental schedules, if available, facilitate an in-depth analytical review. The information from those schedules may give examiners considerable insight into the interpretation of the bank's basic financial statements. To properly understand and interpret a particular bank's financial and statistical data, examiners should be familiar with current economic and industry conditions, including any idiosyncratic cyclical or seasonal factors in the nation, region, and local area that may have an affect on the bank's earnings. Economic and industry information, reports, and journals are useful informational sources of industry conditions and trends. Finally, examiners should be knowledgeable about new banking laws and new accounting standards or methodologies that could have a material effect on financial institutions' business and earnings.

UBPR

The information used to prepare UBPRs are largely based on the Consolidated Reports of

Condition and Income (Call Report). Each UBPR also contains corresponding average data for the bank's peer group (a group of banks of similar asset size and reporting characteristics) and percentile rankings for most ratios. The UBPR facilitates the evaluation of a bank's current condition, trends in its financial performance, and comparisons with the performance of its peer group.

The user's guide for the UBPR explains how a structured approach to financial analysis should be followed.[1] This approach breaks down a bank's income stream into its major components of interest margin performance, overhead, non-interest income, loan-loss provisions, tax factors, and extraordinary items. These major components can then be broken down into various subcomponents. Also, examiners should analyze the balance-sheet composition along with economic conditions to understand the source and future variability of a bank's income stream.

The dollar amounts displayed for most income and expense items in the UBPR are shown for the year-to-date period. However, to allow comparison of ratios between quarters, income and expense and related data used in certain ratios are annualized for interim reporting periods. Thus, the income or expense item is multiplied by the indicated factor listed below before dividing it by the corresponding asset or liability. The UBPR annualization factors are

- March 4.0,
- June 2.0, and
- September 1.3333.

Income and expense information reported on the December 31 Call Report is not annualized. Since the year-end UBPR represents a full fiscal year.

Frequently, examiners need a more detailed and current review of a bank's financial condition than that provided by the UBPR. Under certain circumstances, UBPR procedures may need to be supplemented because—

- asset-quality information must be linked to the income stream;
- more detailed information is necessary on asset-liability maturities and matching;
- more detailed information is necessary on other liquidity aspects, as they may affect earnings;
- yield or cost information, which may be difficult to interpret from the report, is needed;
- certain income or expense items may need clarification, as well as normal examination validation;
- volume information, such as the number of demand deposits, certificates of deposit, and other accounts, is not reported, and vulnerability in a bank subject to concentrations normally should be considered;
- components of interest and fees on loans are not reported separately by category of loan; thus, adverse trends in the loan portfolio may not be detected (for example, the yield of a particular bank's loan portfolio may be similar to those of its peer group, but examiners may detect an upward trend in yields for a specific category of loans. That upward trend might be partially or wholly offset by a downward trend of yields in another category of loans, and examiners should consider further investigating the circumstances applicable to each of those loan categories. A change in yields could be a result of a change in the bank's business model or risk "appetite" for certain types of loans or may indicate a change in loan underwriting standards.); or
- income or expense resulting from a change in the bank's operations, such as the opening of a new branch or starting of a mortgage banking activity or trust department, may skew performance ratios. (When there has been a significant change in a bank's operations, examiners should analyze the potential impact of the change on future bank earnings.)

Review of Management's Budget and Financial Statements

In addition to UBPR analysis, examiners should incorporate a review of management's budget and/or financial projections. In reviewing a bank's projections and individual variances from its operating budget, examiners should be able to identify the sources and trends in the bank's prior and future earnings. Examiners should also verify the reasonableness of the budgeted amounts, frequency of budget review by bank management and the board of directors, and level of involvement of key bank personnel in the budget process.

1. The Federal Financial Institutions Examination Council (FFIEC) provides additional information on the UBPR, including the UBPR User's Guide at www.ffiec.gov/ubpr.htm.

In reviewing a bank's financial statements, examiners should be cognizant of new accounting standards or changes in accounting methodologies. In addition, alternative accounting treatments for similar transactions among peer banks also should be considered because they may produce significantly different results. The analytical review must be based on figures derived under valid accounting practices consistently applied, particularly in the accrual areas. Accordingly, during the analytical review, examiners should work with Reserve Bank accounting specialists to determine any material inconsistencies in the application of accounting principles.

Review of Nonrecurring and Extraordinary Items

When assessing earnings, examiners should be aware of nonrecurring events or actions that have affected a bank's earnings performance, positively or negatively, and should adjust earnings on a tax equivalent (TE) basis for comparison purposes. Although the analysis should reflect adjustments for non-recurring events, examiners should also include within their analysis the impact that these items had on overall earnings performance. Examples of events that may affect earnings include adoption of new accounting standards, extraordinary items, or other actions taken by management that are not considered part of a bank's normal operations such as sales of securities for tax purposes or for some other reason unrelated to active management of the securities portfolio.

The exclusion of nonrecurring events from the analysis allows examiners to analyze the profitability of a bank's core operations without the distortions caused by non-recurring items. By adjusting for these distortions, examiners are better able to compare a bank's current earnings performance against the bank's past performance and industry norms (for example, peer group data).

Compliance with Laws and Regulations Relating to Earnings and Dividends

Examiners should consider the interrelationships that exist among the dividend-payout ratio, the rate of growth of retained earnings, and the bank's ability to cover losses and maintain adequate capital. A bank's earnings should also be more than sufficiently adequate in relation to its current dividend rate. In particular, examiners should consider whether a bank's dividend rate is prudent relative to its financial position and not based on overly optimistic earnings scenarios. See SR-09-4, "Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies."[2] Prudent management dictates that a bank should consider the curtailment of the dividend rate if capital is inadequate and greater earnings retention is required. If it appears that a bank's dividend payout isexcessive or that there is a record of recent operating losses, examiners should refer to sections 5199(b) and 5204 of the United States Revised Statutes and section 208.19 of Regulation H which restrict state member bank dividends. See also this manual's section entitled, "Dividends."

ASSIGNING THE EARNINGS RATING

After performing the appropriate examination procedures and documenting the supervisory assessment of a bank, examiners assign a component Uniform Financial Institution Ratings System rating based on an evaluation of a banks earnings. Examiners assign a rating that addresses the quantity and trend of a bank's earnings, as well as factors that may affect the sustainability or quality of earnings. The quantity as well as the quality of a bank's earnings can be affected by excessive or inadequately managed credit risk that may result in loan losses and require additions to the allowance for loan and lease losses, or by high levels of market risk that may unduly expose an institution's earnings to volatility in interest rates.[3] The quality of earnings may also be diminished by undue reliance on extraordinary gains, nonrecurring events, or favorable tax effects. Future earnings may be adversely affected by an inabil-

2. See also the *Bank Holding Company Supervision Manual* for a discussion of the Board's "Policy Statement on the Payment of Cash Dividends by State Member Banks and Bank Holding Companies."

3. See this manual's section entitled, "Allowance for Loan and Lease Losses," for more information.

ity to forecast or control funding and operating expenses, improperly executed or ill-advised business strategies, or poorly managed or uncontrolled exposure to other risks.

Examiners base their rating of a bank's earnings based upon, but not limited to, an assessment of the following evaluation factors:

- the level of earnings, including trends and stability
- the bank's ability to provide for adequate capital through retained earnings
- the quality and sources of earnings
- the level of expenses in relation to the bank's operations
- the adequacy of the bank's budgeting systems, forecasting processes, and management information systems in general
- the adequacy of the bank's provisions for the allowance for loan and lease losses and other valuation allowance accounts
- the earnings exposure to market risk such as interest rate, foreign exchange, and price risks

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Earnings

FACTORS INFLUENCING LIQUIDITY MANAGEMENT AND TYPES OF LIQUIDITY RISK

Liquidity is a financial institution's capacity to meet its cash and collateral obligations without incurring unacceptable losses. Adequate liquidity is dependent upon the institution's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily operations or the financial condition of the institution. An institution's obligations and the funding sources used to meet them depend significantly on its business mix, balance-sheet structure, and the cash-flow profiles of its on- and off-balance-sheet obligations. In managing their cash flows, institutions confront various situations that can give rise to increased liquidity risk. These include funding mismatches, market constraints on the ability to convert assets into cash or in accessing sources of funds (i.e., market liquidity), and contingent liquidity events. Changes in economic conditions or exposure to credit, market, operation, legal, and reputation risks also can affect an institution's liquidity-risk profile and should be considered in the assessment of liquidity and asset/liability management.

Liquidity risk is the risk to an institution's financial condition or safety and soundness arising from its inability (whether real or perceived) to meet its contractual obligations. Because banking organizations employ a significant amount of leverage in their business activities—and need to meet contractual obligations in order to maintain the confidence of customers and fund providers—adequate liquidity is critical to an institution's ongoing operation, profitability, and safety and soundness.

To ensure it has adequate liquidity, an institution must balance the costs and benefits of liquidity: Too little liquidity can expose an institution to an array of significant negative repercussions arising from its inability to meet contractual obligations. Conversely, too much liquidity can entail substantial opportunity costs and have a negative impact on the firm's profitability.

Note: The guidance complements existing guidance in the *Bank Holding Company Supervision Manual* (section 4010.2) and various SR-letters (see the "References" section).

Effective liquidity management entails the following three elements:

- assessing, on an ongoing basis, the current and expected future needs for funds, and ensuring that sufficient funds or access to funds exists to meet those needs at the appropriate time
- providing for an adequate cushion of liquidity with a stock of liquid assets to meet unanticipated cash-flow needs that may arise from a continuum of potential adverse circumstances that can range from high-probability/low-severity events that occur in daily operations to low-probability/high-severity events that occur less frequently but could significantly affect an institution's safety and soundness
- striking an appropriate balance between the benefits of providing for adequate liquidity to mitigate potential adverse events and the cost of that liquidity

The primary role of liquidity-risk management is to (1) prospectively assess the need for funds to meet obligations and (2) ensure the availability of cash or collateral to fulfill those needs at the appropriate time by coordinating the various sources of funds available to the institution under normal and stressed conditions. Funds needs arise from the myriad of banking activities and financial transactions that create contractual obligations to deliver funds, including business initiatives for asset growth, the provision of various financial products and transaction services, and expected and unexpected changes in assets and the liabilities used to fund assets. Liquidity managers have an array of alternative sources of funds to meet their liquidity needs. These sources generally fall within one of four broad categories:

- net operating cash flows
- the liquidation of assets
- the generation of liabilities
- an increase in capital funds

Funds obtained from operating cash flows arise from net interest payments on assets; net principal payments related to the amortization and maturity of assets; and the receipt of funds from various types of liabilities, transactions, and service fees. Institutions obtain liquidity from operating cash flows by managing the timing and maturity of their asset and liability cash flows, including their ongoing borrowing and debt-issuance programs.

Funds can also be obtained by reducing or liquidating assets. Most institutions incorporate scheduled asset maturities and liquidations as part of their ongoing management of operating cash flows. They also use the potential liquidation of a portion of their assets (generally a portion of the investment portfolio) as a contingent source of funds to meet cash needs under adverse liquidity circumstances. Such contingent funds need to be unencumbered for the purposes of selling or lending the assets and are often termed *liquidity reserves* or *liquidity warehouses* and are a critical element of safe and sound liquidity management. Assessments of the value of unencumbered assets should represent the amount of cash that can be obtained from monetized assets under normal as well as stressed conditions.

Asset securitization is another method that some institutions use to fund assets. Securitization involves the transformation of on-balance-sheet loans (e.g., auto, credit card, commercial, student, home equity, and mortgage loans) into packaged groups of loans in various forms, which are subsequently sold to investors. Depending on the business model employed, securitization proceeds can be both a material source of ongoing funding and a significant tool for meeting future funding needs. Securitization markets may provide a good source of funding; however, institutions should be cautious in relying too heavily on this market as it has been known to shutdown under market stress situations.

Funds are also generated through deposit-taking activities, borrowings, and overall liability management. Borrowed funds may include secured lending and unsecured debt obligations across the maturity spectrum. In the short term, borrowed funds may include purchased fed funds and securities sold under agreements to repurchase (repos). Longer-term borrowed funds may include various types of deposit products, collateralized loans, and the issuance of corporate debt. Depending on their contractual characteristics and the behavior of fund providers, borrowed funds can vary in maturity and availability because of their sensitivity to general market trends in interest rates and various other market factors. Considerations specific to the borrowing institution also affect the maturity and availability of borrowed funds.

External Factors and Exposure to Other Risks

The liquidity needs of a financial institution and the sources of liquidity available to meet those needs depend significantly on the institution's business mix and balance-sheet structure, as well as on the cash-flow profiles of its on- and off-balance-sheet obligations. While management largely determines these internal attributes, external factors and the institution's exposure to various types of financial and operating risks, including interest-rate, credit, operational, legal, and reputational risks, also influence its liquidity profile. As a result, an institution should assess and manage liquidity needs and sources by considering the potential consequences of changes in external factors *along with* the institution-specific determinants of its liquidity profile.

Changes in Interest Rates

The level of prevailing market interest rates, the term structure of interest rates, and changes in both the level and term structure of rates can significantly affect the cash-flow characteristics and costs of, and an institution's demand for, assets, liabilities, and off-balance-sheet (OBS) positions. In turn, these factors significantly affect an institution's funding structure or liquidity needs, as well as the relative attractiveness or price of alternative sources of liquidity available to it. Changes in the level of market interest rates can also result in the acceleration or deceleration of loan prepayments and deposit flows. The availability of different types of funds may also be affected, as a result of options embedded in the contractual structure of assets, liabilities, and financial transactions.

Economic Conditions

Cyclical and seasonal economic conditions can also have an impact on the volume of an institution's assets, liabilities, and OBS positions—and, accordingly, its cash-flow and liquidity profile. For example, during recessions, business demand for credit may decline, which affects the growth of an organization and its liquidity needs. At the same time, subpar economic growth and its impact on employment, bankruptcies, and business failures often create direct and indirect incentives for retail customers to reduce their deposits; a recession may also lead to higher loan delinquencies for financial institutions. All of these conditions have negative implications for an institution's cash flow and overall liquidity. On the other hand, periods of economic growth may spur asset or deposit growth, thus introducing different liquidity challenges.

Credit-Risk Exposures of an Institution

An institution's exposure to credit risk can have a material impact on its liquidity. Nonperforming loans directly reduce otherwise expected cash inflows. The reduced credit quality of problem assets impairs their marketability and potential use as a source of liquidity (either by selling the assets or using them as collateral). Moreover, problem assets have a negative impact on overall cash flows by increasing the costs of loan-collection and -workout efforts.

In addition, the price that a bank pays for funds, especially wholesale and brokered borrowed funds and deposits, will reflect the institution's perceived level of risk exposure in the marketplace. Fund suppliers use a variety of credit-quality indicators to judge credit risk and determine the returns they require for the risk to be undertaken. Such indicators include an institution's loan-growth rates; the relative size of its loan portfolio; and the levels of delinquent loans, nonperforming loans, and loan losses. For institutions that have issued public debt, the credit ratings of nationally recognized statistical rating organizations (NRSOs) are particularly critical.

Other Risk Exposures of an Institution

Importantly, exposures to operational, legal, reputational, and other risks can lead to adverse liquidity conditions. Operating risks can materially disrupt the dispersal and receipt of obligated cash flows and give rise to significant liquidity needs. Exposure to legal and reputational risks can lead fund providers to question an institution's overall credit risk, safety and soundness, and ability to meet its obligations in the future. A bank's reputation for operating in a safe and sound manner, particularly its ability to meet its contractual obligations, is an important determinant in its costs of funds and overall liquidity-risk profile.

Given the critical importance of liquidity to financial institutions and the potential impact that other risk exposures and external factors have on liquidity, effective liquidity managers ensure that liquidity management is fully integrated into the institution's overall enterprise-wide risk-management activities. Liquidity management is therefore an important part of an institution's strategic and tactical planning.

Types of Liquidity Risk

Banking organizations encounter the following three broad types of liquidity risk:

- mismatch risk
- market liquidity risk
- contingent liquidity risk

Mismatch risk is the risk that an institution will not have sufficient cash to meet obligations in the normal course of business, as a result of ineffective matches between cash inflows and outflows. The management and control of funding mismatches depend greatly on the daily projections of operational cash flow, including those cash flows that may arise from seasonal business fluctuations, unanticipated new business, and other everyday situations. To accurately project operational cash flows, an institution needs to estimate its expected cash-flow needs and ensure it has adequate liquidity to meet small variations to those expectations. Occurrences of funding mismatches may be frequent. If adequately managed, these mismatches may have little to no impact on the financial health of the firm.

Market liquidity risk is the risk that an institution will encounter market constraints in its efforts to convert assets into cash or to access financial market sources of funds.

The planned conversion of assets into cash is an important element in an institution's ongoing management of funding cash-flow mismatches. In addition, converting assets into cash is often a key strategic tool for addressing contingent liquidity events. As a result, market constraints on achieving planned, strategic, or contingent conversions of assets into cash can exacerbate the severity of potential funding mismatches and contingent liquidity problems.

Contingent liquidity risk is the risk that arises when unexpected events cause an institution to have insufficient funds to meet its obligations. Unexpected events may be firm-specific or arise from external factors. External factors may be geographic, such as local economic factors that affect the premiums required on deposits with certain local, state, or commercial areas, or they may be market-oriented, such as increases in the price volatility of certain types of securities in response to financial market developments. External factors may also be systemic, such as a payment-system disruption or major changes in economic or financial market conditions.

The nature and severity of contingent liquidity events vary substantially. At one extreme, contingent liquidity risk may arise from the need to fund unexpected asset growth as a result of commitment requests or the unexpected runoff of liabilities that occurs in the normal course of business. At the other extreme, institution-specific issues, such as the lowering of a public debt rating or general financial market stress, may have a significant impact on an institution's liquidity and safety and soundness. As a result, managing contingent liquidity risk requires an ongoing assessment of potential future events and circumstances in order to ensure that obligations are met and adequate sources of standby liquidity and/or liquidity reserves are readily available and easily converted to cash.

Diversification plays an important role in managing liquidity and its various component risks. Concentrations in particular types of assets, liabilities, OBS positions, or business activities that give rise to unique types of funding needs or create an undue reliance on specific types of funding sources can unduly expose an institution to the risks of funding mismatches, contingent events, and market liquidity constraints. Therefore, diversification of both the sources and uses of liquidity is a critical component of sound liquidity-risk management.

SOUND LIQUIDITY-RISK MANAGEMENT PRACTICES

Like the management of any type of risk, sound liquidity-risk management involves effective oversight of a comprehensive process that adequately identifies, measures, monitors, and controls risk exposure. This process includes oversight of exposures to funding mismatches, market liquidity constraints, and contingent liquidity events. Both international and U.S. banking supervisors have issued supervisory guidance on safe and sound practices for managing the liquidity risk of banking organizations. Guidance on liquidity risk management was published by the Basel Committee on Banking Supervision, Bank for International Settlements, "Principles for Sound Liquidity Risk Management and Supervision," in September 2008.[1] The U.S. regulatory agencies implemented these principles, jointly agreeing to incorporate those principles into their existing guidance. The revised guidance, "Interagency Policy Statement on Funding and Liquidity Risk Management" was issued on March 10, 2010 (see SR-10-6 and its attachment).

In summary, the critical elements of a sound liquidity-risk management process are—

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

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

Each of these elements should be customized to account for the sophistication, complexity, and business activities of an institution. The following sections discuss supervisory expectations for each of these critical elements.

Corporate Governance and Oversight

Effective liquidity-risk management requires the coordinated efforts of both an informed board of directors and capable senior management. The board should establish and communicate the institution's liquidity-risk tolerance in such a manner that all levels of management clearly understand the institution's approach to managing the trade-offs between management of liquidity risk and short-term profits. The board should ensure that the organizational structures and staffing levels are appropriate, given the institution's activities and the risks they present.

Involvement of the Board of Directors

The board of directors is ultimately responsible for the liquidity risk assumed by the institution. The board should understand and guide the strategic direction of liquidity-risk management. Specifically, the board of directors or a delegated committee of board members should oversee the establishment and approval of liquidity management strategies, policies and procedures, and review them at least annually. In addition, the board should ensure that it

- understands the nature of the institution's liquidity risks and periodically reviews information necessary to maintain this understanding;
- understands and approves those elements of liquidity-risk management policies that articulate the institution's general strategy for managing liquidity risk, and establishes acceptable risk tolerances;
- establishes executive-level lines of authority and responsibility for managing the institution's liquidity risk;
- enforces management's duties to identify, measure, monitor, and control liquidity risk.
- understands and periodically reviews the institution's CFP for handling potential adverse liquidity events; and
- understands the liquidity-risk profile of important subsidiaries and affiliates and their influence on the overall liquidity of the financial institution, as appropriate.

Role of Senior Management

Senior management should ensure that liquidity-risk management strategies, policies, and procedures are adequate for the sophistication and complexity of the institution. Management should ensure that these policies and procedures are appropriately executed on both a long-term and day-to-day basis, in accordance with board delegations. Management should oversee the development and implementation of—

- an appropriate risk-measurement system and standards for measuring the institution's liquidity risk;
- a comprehensive liquidity-risk reporting and monitoring process;
- establishment and monitoring of liquid asset buffers of unencumbered marketable securities;
- effective internal controls and review processes for the management of liquidity risk; and
- monitoring of liquidity risks for each entity across the institution on an on-going basis and;
- an appropriate CFP, including (1) adequate assessments of the institution's contingent liquidity risks under adverse circumstances and (2) fully developed strategies and plans for managing such events.

Senior management should periodically review the organization's liquidity-risk management strategies, policies, and procedures, as well as its CFP, to ensure that they remain appropriate and sound. Management should also coordinate the institution's liquidity-risk management with its efforts for disaster, contingency, and strategic planning, as well as with its business and risk-management objectives, strategies, and tactics. Senior management is also responsible for regularly reporting to the board of directors on the liquidity-risk profile of the institution.

Strategies, Policies, Procedures, and Risk Tolerances

Institutions should have documented strategies for managing liquidity and have formal written policies and procedures for limiting and controlling risk exposures. Strategies, policies, and procedures should translate the board's goals, objectives, and risk tolerances into operating standards that are well understood by institutional personnel and that are consistent with the board's intended risk tolerances. Policies should also ensure that responsibility for managing liquidity is assigned throughout the corporate structure of the institution, including separate legal entities and relevant operating subsidiaries and affiliates, where appropriate. Strategies set out the institution's general approach for managing liquidity, articulate its liquidity-risk tolerances, and address the extent to which key elements of funds management are centralized or delegated throughout the institution. Strategies also communicate how much emphasis the institution places on using asset liquidity, liabilities, and operating cash flows to meet its day-to-day and contingent funding needs. Quantitative and qualitative targets, such as the following, may also be included in policies:

- guidelines or limits on the composition of assets and liabilities
- the relative reliance on certain funding sources, both on an ongoing basis and under contingent liquidity scenarios
- the marketability of assets to be used as contingent sources of liquidity

An institution's strategies and policies should identify the primary objectives and methods for (1) managing daily operating cash flows, (2) providing for seasonal and cyclical cash-flow fluctuations, and (3) addressing various adverse liquidity scenarios. The latter includes formulating plans and courses of actions for dealing with potential temporary, intermediate-term, and long-term liquidity disruptions. Policies and procedures should formally document—

- lines of authority and responsibility for managing liquidity risk,
- liquidity-risk limits and guidelines,
- the institution's measurement and reporting systems, and
- elements of the institution's comprehensive CFP.

Incorporating these elements of liquidity-risk management into policies and procedures helps internal control and internal audit fulfill their oversight role in the liquidity-risk management process. Policies, procedures, and limits should address liquidity separately for individual currencies, where appropriate and material. All liquidity-risk policies, procedures, and limits should be reviewed periodically and revised as needed.

Delineating Clear Lines of Authority and Responsibility

Through formal written policies or clear operating procedures, management should delineate managerial responsibilities and oversight, including lines of authority and responsibility for the following:

- developing liquidity-risk management policies, procedures, and limits
- developing and implementing strategies and tactics for managing liquidity risk
- conducting day-to-day management of the institution's liquidity
- establishing and maintaining liquidity-risk measurement and monitoring systems
- authorizing exceptions to policies and limits
- identifying the potential liquidity risk associated with the introduction of new products and activities

Institutions should clearly identify the individuals or committees responsible for liquidity-risk decisions. Less complex institutions often assign such responsibilities to the CFO or an equivalent senior management official. Other institutions assign responsibility for liquidity-risk management to a committee of senior managers, sometimes called a finance committee or an asset/liability committee (ALCO). Policies should clearly identify individual or committee duties and responsibilities, the extent of the decision-making authority, and the form and frequency of periodic reports to senior management and the board of directors. In general, an ALCO (or a similar senior-level committee) is responsible for ensuring that (1) measurement systems adequately identify and quantify the institution's liquidity-risk exposure and (2) reporting systems communicate accurate and relevant information about the level and sources of that exposure.

When an institution uses an ALCO or other senior management committee, the committee should actively monitor the liquidity profile of the institution and should have sufficiently broad representation from the major institutional functions that influence liquidity risk (e.g., the lending, investment, deposit, or funding functions). Committee members should include senior managers who have authority over the units responsible for executing transactions and other activities that can affect liquidity. In addition, the committee should ensure that (1) the risk-measurement system adequately identifies and quantifies risk exposure and (2) the reporting process communicates accurate, timely, and relevant information about the level and sources of risk exposure.

In general, committees overseeing liquidity-risk management delegate the day-to-day responsibilities to the institution's treasury department or, at less complex institutions, to the CFO, treasurer, or other appropriate staff. The personnel charged with measuring and monitoring the day-to-day management of liquidity risk should have a well-founded understanding of all aspects of the institution's liquidity-risk profile. While the day-to-day management of liquidity may be delegated, the oversight committee should not be precluded from aggressively monitoring liquidity management.

In more-complex institutions that have separate legal entities and operating subsidiaries or affiliates, effective liquidity-risk management requires senior managers and other key personnel to have an understanding of the funding position and liquidity of any member of the corporate group that might provide or absorb liquid resources from another member. Centralized liquidity-risk assessment and management can provide significant operating efficiencies and comprehensive views of the liquidity-risk profile of the integrated corporate entity as well as members of the corporate group—including depository institutions. This integrated view is particularly important for understanding the impact other members of the group may have on insured depository entities. However, legal and regulatory restrictions on the flow of funds among members of a corporate group, in addition to differences in the liquidity characteristics and dynamics of managing the liquidity of different types of entities within a group, may call for decentralizing various elements of liquidity-risk management. Such delegation and associated strategies, policies, and procedures should be clearly articulated and understood throughout the organization. Policies, procedures, and limits should also address liquidity separately for individual currencies, legal entities, and business lines, when appropriate and material, as well as allow for legal, regulatory, and operational limits for the transferability of liquidity.

Diversified Funding

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

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

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

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

- Deposit growth.
- Lengthening maturities of liabilities.
- Issuance of debt instruments.
- Sale of subsidiaries or lines of business.
- Asset securitization.
- Sale (either outright or through repurchase agreements) or pledging of liquid assets.
- Drawing-down committed facilities.
- Borrowing.

Liquidity-Risk Limits and Guidelines

Liquidity-risk tolerances or limits should be appropriate for the complexity and liquidity-risk profile of an institution. They should employ both quantitative targets and qualitative guidelines and should be consistent with the institution's overall approach and strategy for measuring and managing liquidity. Policies should clearly articulate a liquidity-risk tolerance that is appropriate for the business strategy of the institution, considering its complexity, business mix, liquidity-risk profile, and its role in the financial system. Policies should also contain provisions for documenting and periodically reviewing assumptions used in liquidity projections. Policy guidelines should employ both quantitative targets and qualitative guidelines. These measurements, limits, and guidelines may be specified in terms of the following measures and conditions, as applicable:

- *Discrete or cumulative cash-flow mismatches or gaps (sources and uses of funds) over specified future short- and long-term time horizons under both expected and adverse business conditions.* Often, these are expressed as cash-flow coverage ratios or as specific aggregate amounts.
- *Target amounts of unpledged liquid-asset reserves sufficient to meet liquidity needs under normal and reasonably anticipated adverse business conditions.* These targets are often expressed as aggregate amounts or as ratios calculated in relation to, for example, total assets, short-term assets, various types of liabilities, or projected-scenario liquidity needs.
- *Volatile liability dependence and liquid-asset coverage of volatile liabilities under both normal and stress conditions.* These guidelines, for example, may include amounts of potentially volatile wholesale funding to total liabilities, volatile retail (e.g., high-cost or out-of-market) deposits to total deposits, potentially volatile deposit-dependency measures, or short-term borrowings as a percent of total funding.
- *Asset concentrations that could increase liquidity risk through a limited ability to convert to cash* (e.g., complex financial instruments, bank-owned (corporate-owned) life insurance, and less-marketable loan portfolios).
- *Funding concentrations that address diversification issues, such as a large liability and dependency on borrowed funds, concentrations of single funds providers, funds providers by market segments, and types of volatile deposit or volatile wholesale funding dependency.* For small community banks, funding concentrations may be difficult to avoid. However, banks that rely on just a few primary sources should have appropriate systems in place to manage the concentrations of funding liquidity, including limit structures and reporting mechanisms.
- *Funding concentrations that address the term, re-pricing, and market characteristics of funding sources.* This may include diversification targets for short-, medium-, and long-term funding, instrument type and securitization vehicles, and guidance on concentrations for currencies and geographical markets.
- *Contingent liabilities, such as unfunded loan commitments and lines of credit supporting asset sales or securitizations, and collateral*

requirements for derivatives transactions and various types of secured lending.

- *The minimum and maximum average maturity of different categories of assets and liabilities.*

Institutions may use other risk indicators to specify their risk tolerances. Some institutions may use ratios such as loans to deposits, loans to equity capital, purchased funds to total assets, or other common measures. However, when developing and using such measures, institutions should be fully aware that some measures may not appropriately assess the timing and scenario-specific characteristics of the institution's liquidity-risk profile. *Liquidity-risk measures that are constructed using static balance-sheet amounts may hide significant liquidity risk that can occur in the future under both normal and adverse business conditions. As a result, institutions should not rely solely on these static measures to monitor and manage liquidity.*

Policies on Measuring and Managing Reporting Systems

Policies and procedures should also identify the methods used to measure liquidity risk, as well as the form and frequency of reports to various levels of management and the board of directors. Policies should identify the nature and form of cash-flow projections and other liquidity measures to be used. Policies should provide for the categorization, measurement, and monitoring of both stable and potentially volatile sources of funds. Policies should also provide guidance on the types of business-condition scenarios used to construct cash-flow projections and should contain provisions for documenting and periodically reviewing the assumptions used in liquidity projections.

Moreover, policies should explicitly provide for more-frequent reporting under adverse business or liquidity conditions. Under normal business conditions, senior managers should receive liquidity-risk reports at least monthly, while the board of directors should receive liquidity-risk reports at least quarterly. If the risk exposure is more complex, the reports should be more frequent. These reports should tell senior management and the board how much liquidity risk the bank is assuming, whether management is complying with risk limits, and whether management's strategies are consistent with the board's expressed risk tolerance.

Policies on Contingency Funding Plans

Policies should also provide for senior management to develop and maintain a written, comprehensive, and up-to-date liquidity CFP. Policies should also ensure that, as part of ongoing liquidity-risk management, senior management is alerted to early-warning indicators or triggers of potential liquidity problems.

Compliance with Laws and Regulations

Institutions should ensure that their policies and procedures take into account compliance with appropriate laws and regulations that can have an impact on an institution's liquidity-risk management and liquidity-risk profile. These laws and regulations include the Federal Deposit Insurance Corporation Improvement Act (FDICIA) and its constraints on an institution's use of brokered deposits, as well as pertinent sections of Federal Reserve regulations A, D, F, and W. (See appendix 2, for a summary of some of the pertinent legal and regulatory issues that should be factored into the management of liquidity risk.)

Liquidity-Risk Measurement Systems

The analysis and measurement of liquidity risk should be tailored to the complexity and risk profile of an institution, incorporating the cash flows and liquidity implications of all the institution's material assets, liabilities, off-balance-sheet positions, and major business activities. Liquidity-risk analysis should consider what effect options embedded in the institution's sources and uses of funds may have on its cash flows and liquidity-risk measures. The analysis of liquidity risk should also be forward-looking and strive to identify potential future funding mismatches as well as current imbalances. Liquidity-risk measures should advance management's understanding of the institution's exposure to mismatch, market, and contingent liquidity risks. Measures should also assess the institution's liquidity sources and needs in relation to the specific business environments it operates in and the time frames involved in securing and using funds.

Adequate liquidity-risk measurement requires the ongoing review of an institution's sources and uses of funds and generally includes analysis of the following:

- trends in balance-sheet structure and funding vehicles
- pro forma cash-flow statements and funding mismatch gaps over varying time horizons
- trends and expectations in the volume and pricing trends for assets, liabilities, and off-balance-sheet items that can have a significant impact on the institution's liquidity
- trends in the relative costs of funds required by existing and alternative funds providers
- the diversification of funding sources and trends in funding concentrations
- the adequacy of asset liquidity reserves, trends in these reserves, and the market dynamics that could influence their market liquidity
- the sensitivity of funds providers to both financial market and institution-specific trends and events
- the institution's exposure to both broad-based market and institution-specific contingent liquidity events

The formality and sophistication of liquidity-risk measurement, and the policies and procedures used to govern the measurement process, depend on the sophistication of the institution, the nature and complexity of its funding structures and activities, and its overall liquidity-risk profile.

(See appendix 1, for background information on the types of liquidity analysis and measures of liquidity risk used by effective liquidity-risk managers. The appendix also discusses the considerations for evaluating the liquidity-risk characteristics of various assets, liabilities, OBS positions, and other activities, such as asset securitization, that can influence an institution's liquidity.)

Pro Forma Cash-Flow Analysis

Regardless of the size and complexity of an institution, pro forma cash-flow statements are a critical tool for adequately managing liquidity risk. In the normal course of measuring and managing liquidity risk and analyzing their institution's sources and uses of funds, effective liquidity managers project cash flows under expected and alternative liquidity scenarios. Such cash-flow-projection statements range from simple spreadsheets to very detailed reports, depending on the complexity and sophistication of the institution and its liquidity-risk profile.

A sound practice is to project, on an ongoing basis, an institution's cash flows under normal business-as-usual conditions, incorporating appropriate seasonal and business-growth considerations over varying time horizons. This cash-flow projection should be regularly reviewed under both short-term and intermediate- to long-term institution-specific contingent scenarios. Institutions that have more-complex liquidity-risk profiles should also assess their exposure to broad systemic and adverse financial market events, as appropriate to their business mix and overall liquidity-risk profile (e.g., securitization, derivatives, trading, processing, international, and other activities).

The construction of pro forma cash-flow statements under alternative scenarios and the ongoing monitoring of an institution's liquidity-risk profile depend importantly on liquidity management's review of trends in the institution's balance-sheet structure and its funding sources. This review should consider past experience and include expectations for the volume and pricing of assets, liabilities, and off-balance-sheet items that may significantly affect the institution's liquidity.

Effective liquidity-risk monitoring systems should assess (1) trends in the relative cost of funds, as required by the institution's existing and alternative funds providers; (2) the diversification or concentration of funding sources; (3) the adequacy of the institution's asset liquidity reserves; and (4) the sensitivity of funds providers to both financial market and institution-specific trends and events. *Detailed examples and further discussion of cash-flows are included in appendix 1, section I, "Basic Cash-Flow Projections."*

Assumptions

Given the critical importance of assumptions in constructing liquidity-risk measures and projections of future cash flows, institutions should ensure that all their assumptions are reasonable and appropriate. Institutions should document and periodically review and approve key assumptions. Assumptions used in assessing the liquidity risk of complex instruments and assets; liabilities; and OBS positions that have uncertain cash flows, market value, or maturities should be subject to rigorous documentation and review.

Assumptions about the stability or volatility of retail deposits, brokered deposits, wholesale or secondary-market borrowings, and other funding sources with uncertain cash flows are particularly important—especially when such assumptions are used to evaluate alternative sources of funds under adverse contingent liquidity scenarios (such as a deterioration in asset quality or capital). When assumptions about the performance of deposits and other sources of funds are used in the computation of liquidity measures, these assumptions should be based on reasoned analysis considering such factors as the following:

- the historical behavior of deposit customers and funds providers
- how current or future business conditions may change the historical responses and behaviors of customers and other funds providers
- the general conditions and characteristics of the institution's market for various types of funds, including the degree of competition
- the anticipated pricing behavior of funds providers (for instance, wholesale or retail) under the scenario investigated
- haircuts (that is, the reduction from the stated value of an asset) applied to assets earmarked as contingent liquidity reserves

Further discussion of liquidity characteristics of assets, liabilities, and off-balance-sheet items is included in appendix 1, section III, "Liquidity Characteristics of Assets, Liabilities, Off-Balance-Sheet Positions, and Various Types of Banking Activities." Institutions that have complex liquidity profiles should perform sensitivity tests to determine what effect any changes to its material assumptions will have on its liquidity.

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

Institutions should ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, medium-term horizons of up to one year, and longer-term liquidity needs over one year. These assessments should include vulnerabilities to events, activities, and strategies that can significantly strain the capability to generate internal cash.

Stress Testing

Once normal operating cash-flow statements are established then those tools can be used to generate stress tests. Stress assumptions are simply layered on top of the normal operating cash-flow projections. The quantitative results provided by the stress test also serve as a key component within the CFP.

Institutions should conduct stress tests on a regular basis for a variety of institution-specific and market-wide events across multiple time horizons. The magnitude and frequency of stress testing should be commensurate with the complexity of the financial institution and the level of its risk exposures. Stress test outcomes should be used to identify and quantify sources of potential liquidity strain and to analyze possible impacts on the institution's cash flows, liquidity position, profitability, and solvency.

Stress tests should also be used to ensure that current exposures are consistent with the financial institution's established liquidity-risk tolerance. The stress test serves as a key component of the CFP and the quantification of the risk to which the institution may be exposed. Management's active involvement and support is critical to the effectiveness of the stress-testing process. Management should discuss the results of stress tests and take remedial or mitigating actions to limit the institution's exposures, build up a liquidity cushion, and adjust its liquidity profile to fit its risk tolerance. The results of stress tests therefore play a key role in determining the amount of buffer assets the institution should maintain.

Cushion of Liquid Assets

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

Management should ensure that unencumbered, highly liquid assets are readily available and are not pledged to payment systems or clearing houses. The quality of unencumbered liquid assets is important as it will ensure accessibility during the time of most need. For example, an institution could utilize its holdings of high-quality U.S. Treasury securities, or similar instruments, and enter into repurchase agreements in response to the most severe stress scenarios.

Liquidity-Risk Monitoring and Reporting Systems

Methods used to monitor and measure liquidity risk should be sufficiently robust and flexible to allow for the timely computation of the metrics an institution uses in its ongoing liquidity-risk management. Risk monitoring and reporting systems should regularly provide information on day-to-day liquidity management and risk control; this information should also be readily available during contingent liquidity events.

In keeping with the other elements of sound liquidity-risk management, the complexity and sophistication of management reporting and management information systems (MIS) should be consistent with the liquidity profile of the institution. For example, complex institutions that are highly dependent on wholesale funds may need daily reports on the use of various funding sources, maturities of various instruments, and rollover rates. Less complex institutions may require only simple maturity-gap or cash-flow reports that depict rollovers and mismatch risks; these reports may also include pertinent liquidity ratios. Liquidity-risk reports can be customized to provide management with aggregate information that includes sufficient supporting detail to enable them to assess the sensitivity of the institution to changes in market conditions, its own financial performance, and other important risk factors. Reportable items may include, but are not limited to—

- cash-flow gap-projection reports and forward-looking summary measures that assess both business-as-usual and contingent liquidity scenarios;
- asset and funding concentrations that highlight the institution's dependence on funds that may be highly sensitive to institution-specific contingent liquidity or market liquidity risk (including information on the types and amounts of negotiable certificates of deposit (CDs) and other bank obligations, as well as information on major liquidity funds providers);
- critical assumptions used in cash-flow projections and other measures;
- the status of key early-warning signals or risk indicators;
- funding availability;
- reports on the impact of new products and activities;
- reports documenting compliance with established policies and procedures; and
- where appropriate, both consolidated and unconsolidated reports for institutions that have multiple offices, international branches, affiliates, or subsidiaries.
- Institutions should also report on the use of and availability of government support, such as lending and guarantee programs, and implications on liquidity positions, particularly since these programs are generally temporary or reserved as a source for contingent funding.

The types of reports or information and their timing should be tailored to the institution's funding strategies and will vary according to the complexity of the institution's operations and risk profile. For example, institutions relying on investment securities for their primary source of contingent liquidity should employ reports on the quality, pledging status, and maturity distribution of those assets. Similarly, institutions conducting securitization activities, or placing significant emphasis on the sale of loans to meet contingent liquidity needs, should customize their liquidity reports to target these activities.

Collateral-Position Management

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

Liquidity Across Legal Entities, and Business Lines

An institution should actively monitor and control liquidity-risk exposures and funding needs within and across legal entities and business lines, taking into account legal, regulatory, and operational limitations to the transferability of liquidity. Separately regulated entities will need to maintain liquidity commensurate with their own risk profiles on a stand-alone basis.

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

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

Intraday Liquidity Position Management

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

- monitor and measure expected daily gross liquidity inflows and outflows.
- manage and mobilize collateral when necessary to obtain intraday credit.
- identify and prioritize time-specific and other critical obligations in order to meet them when expected.
- settle other less critical obligations as soon as possible.
- control credit to customers when necessary.

Contingency Funding Plans

A CFP is a compilation of policies, procedures, and action plans for responding to contingent liquidity events. It is a sound practice for all institutions, regardless of size and complexity, to engage in comprehensive contingent liquidity planning. The objectives of the CFP are to provide a plan for responding to a liquidity crisis, identify a menu of contingent liquidity sources that the institution can use under adverse liquidity circumstances, and describe steps that should be taken to ensure that the institution's sources of liquidity are sufficient to fund scheduled operating requirements and meet the institution's commitments with minimal costs and disruption. CFPs should be commensurate with an institution's complexity, risk profile, and scope of operations.

Contingent liquidity events are unexpected situations or business conditions that may increase the risk that an institution will not have sufficient funds to meet liquidity needs. These events can negatively affect any institution, regardless of its size and complexity, by

- interfering with or preventing the funding of asset growth,
- disrupting the institution's ability to renew or replace maturing funds.

Contingent liquidity events may be institution-specific or arise from external factors. Institution-specific risks are determined by the risk profile and business activities of the institution. They generally are a result of unique credit, market, operational, and strategic risks taken by the institution. A potential result of this type of event would be customers unexpectedly exercising options to withdraw deposits or exercise off-balance-sheet (OBS) commitments.

In contrast, external contingent events may be systemic financial-market occurrences, such as

- increases or decreases in the price volatility of certain types of securities in response to market events;
- major changes in economic conditions, market perception, or dislocations in financial markets;
- disturbances in payment and settlement systems due to operational or local disasters.

Contingent liquidity events range from high-probability/low-impact events that occur during the normal course of business to low-probability/high-impact events that may have an adverse impact on an institution's safety and soundness. Institutions should incorporate planning for high-probability/low-impact liquidity risks into their daily management of the sources and uses of their funds. This objective is best accomplished by assessing possible variations in expected cash-flow projections and provisioning for adequate liquidity reserves in the normal course of business.

Liquidity risks driven by lower-probability, higher-impact events should be addressed in the CFP, which should—

- identify reasonably plausible stress events;
- evaluate those stress events under different levels of severity;
- make a quantitative assessment of funding needs under the stress events;
- identify potential funding sources in response to a stress event; and
- provide for commensurate management processes, reporting, and external communication throughout a stress event.

The CFP should address both the severity and duration of contingent liquidity events. The liquidity pressures resulting from low-probability, high-impact events may be immediate and short term, or they may present sustained situations that have long-term liquidity implications. The potential length of an event should factor into decisions about sources of contingent liquidity.

Identifying Liquidity Stress Events

Stress events are those events that may have a significant impact on an institution's liquidity, given its specific balance-sheet structure, business lines, organizational structure, and other characteristics. Possible stress events include changes in credit ratings, a deterioration in asset quality, a prompt-corrective-action (PCA) downgrade, and CAMELS ratings downgrade widening of credit default spreads, operating losses, negative press coverage, or other events that call into question an institution's ability to meet its obligations.

An institution should customize its CFP. Separate CFPs may be required for the parent company and the consolidated banks in a multibank holding company, for separate subsidiaries (when appropriate), or for each significant foreign currency and global political entity, as necessary. These separate CFPs may be necessary because of legal requirements and restrictions, or the lack thereof. Institutions that have significant payment-system operations should have a formal, written plan in place for managing the risk of both intraday and end-of-day funding failures. Failures may occur as a result of system failure at the institution or at an institution from which payments are expected. Clear, formal communication channels should be established between the institution's operational areas responsible for handling payment-system operations.

Assessing Levels of Severity and Timing

The CFP should delineate the various levels of stress severity that can occur during a contingent liquidity event and, for each type of event, identify the institution's response plan at each stage of an event. (As an event unfolds, it often progresses through various stages and levels of severity.) The events, stages, and severity levels identified should include those that cause temporary disruptions, as well as those that may cause intermediate- or longer-term disruptions. Institutions can use the different stages or levels of severity to design early-warning indicators, assess potential funding needs at various points during a developing crisis, and specify comprehensive action plans.

Assessing Funding Needs and Sources of Liquidity

A critical element of the CFP is an institution's quantitative projection and evaluation of its expected funding needs and funding capacity during a stress event. The institution should identify the sequence of responses that it will mobilize during a stress event and commit sources of funds for contingent needs well in advance of a stress-related event. To accomplish this objective, the institution needs to analyze potential erosion in its funding at alternative stages or severity levels of the stress event, as well as analyze the potential cash-flow mismatches that may occur during the various stress scenarios and levels. Institutions should base their analyses on realistic assessments of the behavior of funds providers during the event; they should also incorporate alternative contingency funding sources into their plans. The analysis should also include all material on- and OBS cash flows and their related effects, which should result in a realistic analysis of the institution's cash inflows, outflows, and funds availability at different time intervals throughout the potential liquidity stress event—and allow the institution to measure its ability to fund operations over an extended period.

Common tools to assess funding mismatches include

- *Liquidity-gap analysis*—A cash-flow report that essentially represents a base case estimate of where funding surpluses and shortfalls will occur over various future timeframes.
- *Stress tests*—A pro forma cash-flow report with the ability to estimate future funding surpluses and shortfalls under various liquidity stress scenarios and the institution's ability to fund expected asset growth projections or sustain an orderly liquidation of assets under various stress events.

Identify Potential Funding Sources

Because of the potential for liquidity pressures to spread from one source of funding to another during a significant liquidity event, institutions should identify, well in advance, alternative sources of liquidity and ensure that they have ready access to contingent funding sources. These funding sources will rarely be used in the normal course of business. Therefore, institutions should conduct advance planning to ensure that contingent funding sources are readily available. For example, the sale, securitization, or pledging of assets as collateral requires a review of these assets to determine the appropriate haircuts and to ensure compliance with the standards required for executing the strategy. Administrative procedures and agreements should also be in place before the institution needs to access the planned source of liquidity. Institutions should identify what advance steps they need to take to promote the readiness of each of their sources of standby liquidity.

Processes for Managing Liquidity Events

The CFP should identify a reliable crisis-management team and an administrative structure for responding to a liquidity crisis, including realistic action plans executing each element of the plan for each level of a stress event. Frequent communication and reporting among crisis team members, the board of directors, and other affected managers optimizes the effectiveness of a contingency plan by ensuring that business decisions are coordinated to minimize further liquidity disruptions. Effective management of a stress event requires the daily computation of regular liquidity-risk reports and supplemental information. The CFP should provide for more-frequent and more-detailed reporting as a stress situation intensifies. Reports that should be available in a funding crisis include—

- a CD breakage report to identify early redemptions of CDs;
- funding-concentration reports;
- cash-flow projections and run-off reports;
- funding-availability or -capacity reports, by types of funding; and
- reports on the status of contingent funding sources.

Framework for Monitoring Contingent Events

Financial institutions should monitor for potential liquidity stress events by using early-warning indicators and event triggers. These indicators should be tailored to an institution's specific liquidity-risk profile. By recognizing potential stress events early, the institution can proactively position itself into progressive states of readiness as an event evolves. This proactive stance also provides the institution with a framework for reporting or communicating among different institutional levels and to outside parties. Early-warning signals may include but are not limited to—

- rapid asset growth that is funded with potentially volatile liabilities;
- growing concentrations in assets or liabilities;
- negative trends or heightened risk associated with a particular product line;
- rating-agency actions (e.g., agencies watch-listing the institution or downgrading its credit rating);
- negative publicity;
- significant deterioration in the institution's earnings, asset quality, and overall financial condition;
- widening debt or credit-default-swap spreads;
- difficulty accessing longer-term funding;
- increasing collateral margin requirements;
- rising funding costs in a stable market;
- increasing redemptions of CDs before maturity;
- counterparty resistance to OBS products;
- counterparties that begin requesting backup collateral for credit exposures; and
- correspondent banks that eliminate or decrease their credit lines.

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

In addition to early-warning indicators, institutions that issue public debt, use warehouse financing, securitize assets, or engage in material OTC derivative transactions typically have exposure to event triggers that are embedded in the legal documentation governing these transactions. These triggers protect the investor or counterparty if the institution, instrument, or underlying asset portfolio does not perform at certain predetermined levels. Institutions that rely upon brokered deposits should also incorporate PCA-related downgrade triggers into their CFPs since a change in PCA status could have a material bearing on the availability of this funding source. Contingent event triggers should be an integral part of the liquidity-risk monitoring system.

Asset-securitization programs pose heightened liquidity concerns because an early-amortization event could produce unexpected funding needs. Liquidity contingency plans should address this risk, if it is material to the institution. The unexpected funding needs associated with an early amortization of a securitization event pose liquidity concerns for the originating bank. The triggering of an early-amortization event can result in the securitization trust immediately passing principal payments through to investors. As the holder of the underlying assets, the originating institution is responsible for funding new charges that would normally have been purchased by the trust. Financial institutions that engage in asset securitization should have liquidity contingency plans that address this potential unexpected funding requirement. Management should receive and review reports showing the performance of the securitized portfolio in relation to the early-amortization triggers.[2]

Securitization covenants that cite supervisory thresholds or adverse supervisory actions as triggers for early-amortization events are considered an unsafe and unsound banking practice that undermines the objective of supervisory actions. An early amortization triggered by a supervisory action can create or exacerbate liquidity and earnings problems that can lead to further deterioration in the financial condition of the banking organization.[3]

Securitizations of asset-backed commercial paper programs (ABCPs) are generally supported by a liquidity facility or commitment to purchase assets from the trust if funds are needed to repay the underlying obligations. Liquidity needs can result from either cash-flow mismatches between the underlying assets and scheduled payments of the overriding security or from credit-quality deterioration of the underlying asset pool. Therefore, the use of liquidity facilities introduces additional risk to the institution, and a commensurate capital charge is required.[4]

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

Testing the CFP

Periodic testing of the operational elements of the CFP is an important part of liquidity-risk management. By testing the various operational elements of the CFP, institutions can prevent unexpected impediments or complications in accessing standby sources of liquidity during a contingent liquidity event. It is prudent to test the operational elements of a CFP that are associated with the securitization of assets, repurchase lines, Federal Reserve discount window borrowings, or other borrowings, since efficient collateral processing during a crisis is especially important for such sources. Institutions should carefully consider whether to include unsecured funding lines in their CFPs, since these lines may be unavailable during a crisis.

Larger, more-complex institutions can benefit from operational simulations that test communications, coordination, and decision-making of managers who have different responsibilities, who are in different geographic locations, or who are located at different operating subsidiaries. Simulations or tests run late in the day can highlight specific problems, such as late-day staffing deficiencies or difficulty selling assets or borrowing new funds near the closing time of the financial markets.

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Internal Controls

An institution's internal controls consist of policies, procedures, approval processes, reconciliations, reviews, and other types of controls to provide assurances that the institution manages liquidity risk in accordance with the board's strategic objectives and risk tolerances. Appropriate internal controls should address relevant elements of the risk-management process, including the institution's adherence to policies and procedures; the adequacy of its risk identification, risk measurement, and risk reporting; and its compliance with applicable rules and regulations. The results of reviews of the liquidity-risk management process, along with any recommendations for improvement, should be reported to the board of directors, which should take appropriate and timely action.

2. See sections 2130.1, 3020.1, and 4030.1, and the *OCC Handbook on Credit Card Lending*, October 1996.

3. SR-02-14, "Covenants in Securitization Documents Linked to Supervisory Actions or Thresholds."

4. SR-05-13, "Interagency Guidance on the Eligibility of ABCP Liquidity Facilities and the Resulting Risk-Based Capital Treatment."

An important element of a bank's internal controls is management's comprehensive evaluation and review. Management should ensure that an independent party regularly reviews and evaluates the components of the institution's liquidity-risk management process. These reviews should assess the extent to which the institution's liquidity-risk management complies with both supervisory guidance and industry sound practices, taking into account the level of sophistication and complexity of the institution's liquidity-risk profile. In larger, complex institutions, an internal audit function usually performs this review. Smaller, less complex institutions may assign the responsibility for conducting an independent evaluation and review to qualified individuals who are independent of the function they are assigned to review. The independent review should report key issues requiring attention, including instances of noncompliance, to the appropriate level of management to initiate a prompt correction of the issues, consistent with approved policies.

Periodic reviews of the liquidity-risk management process should address any significant changes that have occurred since the last review, such as changes in the institution's types or characteristics of funding sources, limits, and internal controls. Reviews of liquidity-risk measurement systems should include assessments of the assumptions, parameters, and methodologies used. These reviews should also seek to understand, test, and document the current risk-measurement process; evaluate the system's accuracy; and recommend solutions to any identified weaknesses.

Controls for changes to the assumptions the institution uses to make cash-flow projections should require that the assumptions not be altered without clear justification consistent with approved strategies. The name of the individual authorizing the change, along with the date of the change, the nature of the change, and justification for each change, should be fully documented. Documentation for all assumptions used in cash-flow projections should be maintained in a readily accessible, understandable, and auditable form. Because liquidity-risk measurement systems may incorporate one or more subsidiary systems or processes, institutions should ensure that multiple component systems are well integrated and consistent with each other.

LIQUIDITY-RISK MANAGEMENT FOR BANK HOLDING COMPANIES

Bank holding companies (BHCs) should develop and maintain liquidity-risk management processes and funding programs that are consistent with their level of sophistication and complexity. For BHCs (includes financial holding companies, which are BHCs) see the *Bank Holding Company Supervision Manual*, section 4066, *"Funding and Liquidity Risk Management,"* and sections 1050.0 and 1050.1, that discuss the consolidated supervision of BHCs. See also SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management." Also see sections 4010.0, "Parent Only—Debt Servicing Capacity/Cash Flow" and 4010.2 "Parent Only—Liquidity."

SUPERVISORY PROCESS FOR EVALUATING LIQUIDITY RISK

Liquidity risk is a primary concern for all banking organizations and is an integral component of the CAMELS rating system. Examiners should consider liquidity risk during the preparation and performance of all on-site safety-and-soundness examinations as well as during targeted supervisory reviews. To meet examination objectives efficiently and effectively and remain sensitive to potential burdens imposed on institutions, examiners should follow a structured, risk-focused approach for the examination of liquidity risk. Key elements of this examination process include off-site monitoring and a risk assessment of the institution's liquidity-risk profile. These elements will help the examiner develop an appropriate plan and scope for the on-site examination, thus ensuring the exam is as efficient and productive as possible. A fundamental tenet of the risk-focused examination approach is the targeting of supervisory resources at functions, activities, and holdings that pose the most risk to the safety and soundness of an institution.

For smaller institutions that have less complex liquidity profiles, stable funding sources, and low exposures to contingent liquidity circumstances, the liquidity element of an examination may be relatively simple and straightforward. On the other hand, if an institution is experiencing significant asset and product growth;

is highly dependent on potentially volatile funds; or has a complex business mix, balance-sheet structure, or liquidity-risk profile that exposes the institution to contingent liquidity risks, that institution should generally receive greater supervisory attention. Given the contingent nature of liquidity risk, institutions whose corporate structure gives rise to inherent operational risk, or institutions encountering difficulties associated with their earnings, asset quality, capital adequacy, or market sensitivity, should be especially targeted for review of the adequacy of their liquidity-risk management.

Off-Site Risk Assessment

In off-site monitoring and analysis, a preliminary view, or *risk assessment,* is developed before initiating an on-site examination. Both the inherent level of an institution's liquidity-risk exposure and the quality of its liquidity-risk management should be assessed to the fullest extent possible during the off-site phase of the examination process. The following information can be helpful in this assessment:

- organizational charts and policies that identify authorities and responsibilities for managing liquidity risk
- liquidity policies, procedures, and limits
- ALCO committee minutes and reports (minutes and reports issued since the last examination or going back at least six to twelve months before the examination)
- board of directors reports on liquidity-risk exposures
- audit reports (both internal and external)
- other available internal liquidity-risk management reports, including cash-flow projections that detail key assumptions
- internal reports outlining funding concentrations, the marketability of assets, analysis that identifies the relative stability or volatility of various types of liabilities, and various cash-flow coverage ratios projected under adverse liquidity scenarios
- supervisory surveillance reports and supervisory screens
- external public debt ratings (if available)

Quantitative liquidity exposure should be assessed by conducting as much of the supervisory review off-site as practicable. This off-site work includes assessing the bank's overall liquidity-risk profile and the potential for other risk exposures, such as credit, market, operational, legal, and reputational risks, that may have a negative impact on the institution's liquidity under adverse circumstances. These assessments can be conducted on a preliminary basis using supervisory screens, examiner-constructed measures, internal bank measures, and cash-flow projections obtained from management reports received before the on-site engagement. Additional factors to be incorporated in the off-site risk assessment include the institution's balance-sheet composition and the existence of funding concentrations, the marketability of its assets (in the context of liquidation, securitization, or use of collateral), and the institution's access to secondary markets of liquidity.

The key to assessing the quality of management is an organized discovery process aimed at determining whether appropriate corporate-governance structures, policies, procedures, limits, reporting systems, CFPs, and internal controls are in place. This discovery process should, in particular, ascertain whether all the elements of sound liquidity-risk management are applied consistently. The results and reports of prior examinations, in addition to internal management reports, provide important information about the adequacy of the institution's risk management.

Examination Scope

The off-site risk assessment provides the examiner with a preliminary view of both the adequacy of liquidity management and the magnitude of the institution's exposure. The scope of the on-site liquidity-risk examination should be designed to confirm or reject the off-site hypothesis and should target specific areas of interest or concern. In this way, on-site examination procedures are tailored to the institution's activities and risk profile and use flexible and targeted work-documentation programs. In general, if liquidity-risk management is identified as adequate, examiners can rely more heavily on a bank's internal liquidity measures for assessing its inherent liquidity risk.

The examination scope for assessing liquidity risk should be commensurate with the complexity of the institution and consistent with the off-site risk assessment. For example, only baseline examination procedures would be used for institutions whose off-site risk assessment indicates that they have adequate liquidity-risk management processes and low levels of inherent liquidity exposure. These institutions include those that have noncomplex balance-sheet structures and banking activities and that also meet the following criteria:

- well capitalized; minimal issues with asset quality, earnings, and market-risk-sensitive activities
- adequate reserves of marketable securities that can serve as standby sources of liquidity
- minimal funding concentrations
- funding structures that are principally composed of stable liabilities
- few OBS items, such as loan commitments, that represent contingent liquidity draws
- minimal potential exposure to legal and reputational risk
- formal adoption of well-documented liquidity-management policies, procedures, and CFPs

For these and other institutions identified as potentially low risk, the scope of the on-site examination would consist of only those examination procedures necessary to confirm the risk-assessment hypothesis. The adequacy of liquidity-risk management could be verified through a basic review of the appropriateness of the institution's policies, internal reports, and controls and its adherence to them. The integrity and reliability of the information used to assess the quantitative level of risk could be confirmed through limited sampling and testing. In general, if basic examination procedures validate the risk assessment, the examiner may conclude the examination process.

High levels of inherent liquidity risk may arise if an institution has concentrations in specific business activities, products, and sectors, or if it has balance-sheet risks, such as unstable liabilities, risky assets, or planned asset growth without an adequate plan for funding the asset growth. OBS items that have uncertain cash inflows may also be a source of inherent liquidity risk. Institutions for which a risk assessment indicated high levels of inherent liquidity-risk exposure and strong liquidity management may require a more extensive examination scope to confirm the assessment. These expanded procedures may entail more analysis of the institution's liquidity-risk measurement system and its liquidity-risk profile. When high levels of liquidity-risk exposure are found, examiners should focus special attention on the sources of this risk. When a risk assessment indicates an institution has high exposure and weak risk-management systems, an extensive work-documentation program is required. The institution's internal measures should be used cautiously, if at all.

Regardless of the sophistication or complexity of an institution, examiners must use care during the on-site phase of an examination to confirm the off-site risk assessment and identify issues that may have escaped off-site analysis. Accordingly, the examination scope should be adjusted as on-site findings dictate.

Assessing CAMELS "L" Ratings

The assignment of the "L" rating is integral to the CAMELS ratings process for commercial banks. Examination findings on both (1) the inherent level of an institution's liquidity risk and (2) the adequacy of its liquidity-risk management process should be incorporated in the assignment of the "L" rating. Findings on the adequacy of liquidity-risk management should also be reflected in the CAMELS "M" rating for risk management.

Examiners can develop an overall assessment of an institution's liquidity-risk exposure by reviewing the various characteristics of its assets, liabilities, OBS instruments, and material business activities. An institution's asset credit quality, earnings integrity, and market risk may also have significant implications for its liquidity-risk exposure. Importantly, assessments of the adequacy of an institution's liquidity-management practices may affect the assessment of its inherent level of liquidity risk. For institutions judged to have sound and timely liquidity-risk measurement and reporting systems and CFPs, examiners may use the results of the institution's adverse-scenario cash-flow projections in order to gain insight into its level of inherent exposure. Institutions that have less-than-adequate measurement and reporting systems and CFPs may have higher exposure to liquidity risk as a result of their potential inability to respond to adverse liquidity events.

Elements of strong liquidity-risk management are particularly important during stress events and include many of the items discussed previously: communication among the departments responsible for managing liquidity, reports that indicate a diversity of funding sources, standby funding sources, cash-flow analyses, liquidity stress tests, and CFPs. Liquidity-risk management should also manage the ongoing costs of maintaining liquidity.

Liquidity risk should be rated in accordance with the Uniform Financial Institutions Rating System (UFIRS).[5] The assessment of the adequacy of liquidity-risk management should provide the primary basis for reaching an overall assessment on the "L" component rating since it is a leading indicator of potential liquidity-risk exposure. Accordingly, overall ratings for liquidity-risk sensitivity should be no greater than the rating given to liquidity-risk management.

In evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared with funding needs, as well as to the adequacy of funds-management practices relative to the institution's size, complexity, and risk profile. In general, funds-management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds-management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions.

Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

- the adequacy of liquidity sources compared with present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition
- the availability of assets readily convertible to cash without undue loss
- access to money markets and other sources of funding
- the level of diversification of funding sources, both on- and off-balance-sheet
- the degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, to fund longer-term assets
- the trend and stability of deposits
- the ability to securitize and sell certain pools of assets
- the capability of management to properly identify, measure, monitor, and control the institution's liquidity position, including the effectiveness of funds-management strategies, liquidity policies, management information systems, and CFPs

Ratings of liquidity-risk management should follow the general framework used to rate overall risk management:

- A rating of 1 indicates strong liquidity levels and well-developed funds-management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
- A rating of 2 indicates satisfactory liquidity levels and funds-management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds-management practices.
- A rating of 3 indicates liquidity levels or funds-management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds-management practices.
- A rating of 4 indicates deficient liquidity levels or inadequate funds-management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.
- A rating of 5 indicates liquidity levels or funds-management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Unsafe liquidity-risk exposures and weaknesses in managing liquidity risk should be fully reflected in the overall liquidity-risk ratings.

5. SR-96-38, "Uniform Financial Institutions Rating System" and section A.5020.1.

Unsafe exposures and unsound management practices that are not resolved during the on-site examination should be addressed through subsequent follow-up actions by the examiner and other supervisory personnel.

REFERENCES

The following sources provide additional information on liquidity-risk management:

- *Bank Holding Company Supervision Manual*, Board of Governors of the Federal Reserve System.
- Basel Committee on Banking Supervision, "Sound Practices for Managing Liquidity in Banking Organisations," publication 69, February 2000.
- "Determining Conformance With Interest Rate Restrictions for Less Than Well Capitalized Institutions," Federal Deposit Insurance Corporation, November 3, 2009 (FIL 62-2009)
- Federal Deposit Insurance Corporation, *Risk Management Manual of Examination Policies*, section 6.1—"Liquidity and Funds Management."
- Federal Financial Institutions Examination Council, Uniform Bank Performance Report.
- Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010
- Office of the Comptroller of the Currency, *Comptroller's Handbook (Safety & Soundness)*, "Liquidity," February 2001.
- "Process for Determining If An Institution Subject to Interest-Rate Restrictions is Operating in a High-Rate Area," Federal Deposit Insurance Corporation, December 4, 2009 (FIL 69-2009)
- SR-01-08, "Supervisory Guidance on Complex Wholesale Borrowings," Board of Governors of the Federal Reserve System, April 5, 2001.
- SR-01-14, "Joint Agency Advisory on Rate-Sensitive Deposits," Board of Governors of the Federal Reserve System, May 31, 2001.
- SR-03-15, "Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management," Board of Governors of the Federal Reserve System, July 25, 2003.
- SR-10-6, "Interagency Policy Statement on Funding and Liquidity-Risk Management," Board of Governors of the Federal Reserve System, March 17, 2010.
- *Trading and Capital-Markets Activities Manual*, Board of Governors of the Federal Reserve System.

APPENDIX 1—FUNDAMENTALS OF LIQUIDITY-RISK MEASUREMENT

Measuring a financial institution's liquidity-risk profile and identifying alternative sources of funds to meet cash-flow needs are critical elements of sound liquidity-risk management. The liquidity-measurement techniques and the liquidity measures employed by depository institutions vary across a continuum of granularity, specificity, and complexity, depending on the specific characteristics of the institution and the intended users of the information. At one extreme, highly granular cash-flow projections under alternative scenarios are used by both complex and noncomplex firms to manage their day-to-day funding mismatches in the normal course of business and for assessing their contingent liquidity-risk exposures. At the other end of the measurement spectrum, aggregate measures and various types of liquidity ratios are often employed to convey summary views of an institution's liquidity-risk profile to various levels of management, the board of directors, and other stakeholders. As a result of this broad continuum, effective managers generally use a combination of cash-flow analysis and summary liquidity-risk measures in managing their liquidity-risk exposures, since no one measure or measurement technique can adequately capture the full dynamics of a financial institution's liquidity-risk exposure.

This appendix provides background material on the basic elements of liquidity-risk measurement and is intended to enhance examiners' understanding of the key elements of liquidity-risk management. First, the fundamental structure of cash-flow-projection worksheets and their use in assessing cash-flow mismatches under both normal business conditions and contingent liquidity events are discussed. The appendix then discusses the key liquidity characteristics of common depository institution assets, liabilities, off-balance-sheet (OBS) items, and other activities. These discussions also present key management considerations surrounding various sources and uses of liquidity in constructing cash-flow worksheets and addressing funding gaps under both normal and adverse conditions. Finally, commonly used summary liquidity measures and ratios are discussed, along with special considerations that should enter into the construction and use of these summary measures.[6]

I. Basic Cash-Flow Projections

In measuring an institution's liquidity-risk profile, effective liquidity managers estimate cash inflows and cash outflows over future periods. For day-to-day operational purposes, cash-flow projections for the next day and subsequent days out over the coming week are used in order to ensure that contractual obligations are met on time. Such daily projections can be extended out beyond a one-week horizon, although it should be recognized that the further out such projections are made, the more susceptible they become to error arising from unexpected changes.

For planning purposes, effective liquidity managers project cash flows out for longer time horizons, employing various incremental time periods, or "buckets," over a chosen horizon. Such buckets may encompass forward weeks, months, quarters, and, in some cases, years. For example, an institution may plan its cash inflows and outflows on a daily basis for the next 5–10 business days, on a weekly basis over the coming month or quarter, on a monthly basis over the coming quarter or quarters, and on a quarterly basis over the next half-year or year. Such cash-flow bucketing is usually compiled into a single cash-flow-projection worksheet or report that represents cash flows under a specific future scenario. The goal of this bucketing approach is a measurement system with sufficient granularity to (1) reveal the time dimension of the needs and sources of liquidity and (2) identify potential liquidity-risk exposure to contingent events.

In its most basic form, a cash-flow-projection worksheet is a table with columns denoting the selected time periods or buckets for which cash flows are to be projected. The rows of this table consist of various types of assets, liabilities, and OBS items, often grouped by their cash-flow characteristics. Different groupings may be used to achieve different objectives of the cash-flow projection. For each row, net cash flows arising from the particular asset, liability, or OBS activity are projected across the time buckets.

The detail and granularity of the rows, and thus the projections, depend on the sophistication and complexity of the institution. Complex banks generally favor more detail, while less complex banks may use higher levels of aggregation. Static projections based only on the contractual cash flows of assets, liabilities, and OBS items as of a point in time are helpful for identifying gaps between needs and sources of liquidity. However, static projections may inadequately quantify important aspects of potential liquidity risk because they ignore new business, funding renewals, customer options, and other potential events that may have a significant impact on the institution's liquidity profile. Since liquidity managers are generally interested in evaluating how available liquidity sources may cover both expected and potential unexpected liquidity needs, a dynamic analysis that includes management's projected changes in cash flows is normally far more useful than a static projection based only on contractual cash flows as of a given projection date.

In developing a cash-flow-projection worksheet, cash inflows occurring within a given time horizon or time bucket are represented as positive numbers, while outflows are represented as negative numbers. Cash inflows include increases in liabilities as well as decreases in assets, and cash outflows include decreases in liabilities as well as increases in assets. For each type of asset, liability, or OBS item, and in each time bucket, the values shown in the cells of the projected worksheet are net cash-flow numbers. One format for a cash-flow-projection worksheet arrays sources of net cash inflows (such as loans and securities) in one group and sources of net cash outflows (such as deposit runoffs) in another. For example, the entries across time buckets for a loan or loan category would net the positives (cash inflows) of projected interest, scheduled principal payments, and prepayments with the negatives (cash outflows) of customer draws on existing commitments and new loan growth in each appropriate time bucket. Summing the net cash flows within a given column or time bucket identifies the extent of maturity mismatches that may exist. Funding shortfalls caused by mismatches in particular time frames

6. Material presented in this appendix draws from the OCC *Liquidity Handbook,* FDIC guidance, Federal Reserve guidance, findings from Federal Reserve supervision reviews, and other material developed for the Federal Reserve by consultants and other outside parties.

are revealed as a ‘‘negative gap,’’ while excess funds within a time bucket denote a ‘‘positive gap.’’ Identifying such gaps early can help managers take the appropriate action to either fill a negative gap or reduce a positive gap. The subtotals of the net inflows and net outflows may also be used to construct net cash-flow coverage ratios or the ratio of net cash inflows to net cash outflows.

The specific worksheet formats used to array sources and uses of cash can be customized to achieve multiple objectives. Exhibit 1 provides an example of one possible form of a cash-flow-projection worksheet. The time buckets (columns) and sources and uses (rows) are selected for illustrative purposes, as the specific selection will depend on the purpose of the particular cash-flow projection. In this example, assets and liabilities are grouped into two broad categories: those labeled ‘‘customer-driven cash flows’’ and those labeled ‘‘management-controlled cash flows.’’ This grouping arrays projected cash flows on the basis of the relative extent to which funding managers may have control over changes in the cash flows of various assets, liabilities, OBS items, and other activities that have an impact on cash flow. For example, managers generally have less control over loan and deposit cash flows (e.g., changes arising from either growth or attrition) and more control over such items as fed funds sold, investment securities, and borrowings.

The net cash-flow gap illustrated in the next-to-the-last row of exhibit 1 is the sum of the net cash flows in each time-bucket column and reflects the funding gap that will have to be financed in that time period. For the daily time buckets, this gap represents the net overnight position that needs to be funded in the unsecured short-term (e.g., fed funds) market. The final row of the exhibit identifies a cumulative net cash-flow gap, which is constructed as the sum of the net cash flows in that particular time bucket and all previous time buckets. It provides a running picture across time of the cumulative funding sources and needs of the institution. The worksheet presented in exhibit 1 is only one of many alternative formats that can be used in measuring liquidity gaps.

II. Scenario Dependency of Cash-Flow Projections

Cash-flow-projection worksheets describe an institution’s liquidity profile under an established set of assumptions about the future.

The set of assumptions used in the cash-flow projection constitutes a specific scenario customized to meet the liquidity manager’s objective for the forecast. Effective liquidity managers generally use multiple forecasts and scenarios to achieve an array of objectives over planning time horizons. For example, they may use three broad types of scenarios every time they make cash-flow projections: normal-course-of-business scenarios; short-term, institution-specific stress scenarios; and more-severe, intermediate-term, institution-specific stress scenarios. Larger, more complex institutions that engage in significant capital-markets and derivatives activities also routinely project cash flows for various systemic scenarios that may have an impact on the firm. Each scenario requires the liquidity manager to assess and plan for potential funding shortfalls. Importantly, no single cash-flow projection reflects the range of liquidity sources and needs required for advance planning.

Normal-course-of-business scenarios establish benchmarks for the ‘‘normal’’ behavior of cash flows of the institution. The cash flows projected for such scenarios are those the institution expects under benign conditions and should reflect seasonal fluctuations in loans or deposit flows. In addition, expected growth in assets and liabilities is generally incorporated to provide a dynamic view of the institution’s liquidity needs under normal conditions.

Adverse, institution-specific scenarios are those that subject the institution to constrained liquidity conditions. Such scenarios are generally defined by first specifying the type of liquidity event to be considered and then identifying various levels or stages of severity for that type of event. For example, institutions that do not have publicly rated debt generally employ scenarios that entail a significant deterioration in the credit quality of their loan and security holdings. Institutions that have publicly rated debt generally include a debt-rating downgrade scenario in their CFPs. The downgrade of an institution’s public debt rating might be specified as one type of event, with successively lower ratings grades, including below-investment-grade ratings, to identify increasing

Exhibit 1—Example Cash-Flow-Projection Worksheet

	Day 1	*Week 1*	*Week 2*	*Week 3*	*Month 1*	*Month 3*	*Months 4–6*	*Months 7–12*
Customer-driven cash flows								
Consumer loans								
Business loans								
Residential mortgage loans								
Fixed assets								
Other assets								
Noninterest-bearing deposits								
NOW accounts								
MMDAs								
Passbook savings								
Statement savings								
CDs under $100,000								
Jumbo CDs								
Net noninterest income								
Miscellaneous and other liabilities								
Other								
Subtotal								
Management-controlled cash flows								
Investment securities								
Repos, FFP, & other short-term borrowings								
FHLB & other borrowings								
Committed lines								
Uncommitted lines								
Other								
Subtotal								
Net cash-flow gap								
Cumulative position								

levels of severity. Each level of severity can be viewed as an individual scenario for planning purposes. Effective liquidity managers ensure that they choose potential adverse liquidity scenarios that entail appropriate degrees of severity and model cash flows consistent with each level of stress. Events that limit access to important sources of funding are the most common institution-specific scenarios used.

The same type of cash-flow-projection worksheet format shown in exhibit 1 can be used for adverse, institution-specific scenarios. However, in making such cash-flow projections, some institutions find it useful to organize the accounts differently to accommodate a set of very different assumptions from those used in the normal-course-of-business scenarios. Exhibit 2 presents a format in which accounts are organized by those involving potential cash outflows and cash inflows. This format focuses the analysis first on liability erosion and potential off-balance-sheet draws, followed by an evaluation of the bank's ability to cover potential runoff, primarily from assets that can be sold or pledged. Funding sources are arranged by their sensitivity to the chosen scenario. For example, deposits may be segregated into insured and uninsured portions. The time buckets used are generally of a shorter

Exhibit 2—Example Cash-Flow-Projection Worksheet—Liquidity Under an Adverse Scenario

Potential outflows/funding erosion	*Day 1*	*Day 2*	*Days 3–7*	*Week 2*	*Week 3*	*Week 4*	*Month 2*	*Months 2+*
Federal funds purchased								
Uncollateralized borrowings (sub-debt, MTNs, etc.)								
Nonmaturity deposits: insured								
— Noninterest-bearing deposits								
— NOW accounts								
— MMDAs								
— Savings								
Nonmaturity deposits: uninsured								
— Retail CDs under $100,000								
— Jumbo CDs								
— Brokered CDs								
— Miscellaneous and other liabilities								
Subtotal								
Off-balance-sheet funding requirements								
Loan commitments								
Amortizing securitizations								
Out-of-the-money derivatives								
Backup lines								
Total potential outflows								
Potential sources to cover outflows								
Overnight funds sold								
Unencumbered investment securities (with appropriate haircut)								
Residential mortgage loans								
Consumer loans								
Business loans								
Fixed/other assets								
Unsecured borrowing capacity								
Brokered-funds capacity								
Total potential inflows								
Net cash flows								
Coverage ratio (inflows/outflows)								
Cumulative coverage ratio								

term than those used under business-as-usual scenarios, reflecting the speed at which deteriorating conditions can affect cash flows.

A key goal of creating adverse-situation cash-flow projections is to alert management as to whether incremental funding resources available under the constraints of each scenario are sufficient to meet the incremental funding needs that result from that scenario. To the extent that projected funding deficits are larger than (or projected funding surpluses are smaller than) desired levels, management has the opportunity to adjust its liquidity position or develop strategies to bring the institution back within an acceptable level of risk.

Adverse systemic scenarios entail macroeconomic, financial market, or organizational events that can have an adverse impact on the institution and its funding needs and sources. Such scenarios are generally customized to the individual institution's funding characteristics and business activities. For example, an institution involved in clearing and settlement activities may choose to model a payments-system disruption, while a bank heavily involved in capital-markets transactions may choose to model a capital-markets disruption.

The number of cash-flow projections necessary to fully assess potential adverse liquidity scenarios can result in a wealth of information that often requires summarization in order to appropriately communicate contingent liquidity-risk exposure to various levels of management. Exhibit 3 presents an example of a report format that assesses available sources of liquidity under alternative scenarios. The worksheet shows the amount of anticipated funds erosion and potential sources of funds under a number of stress scenarios, for a given time bucket (e.g., overnight, one week, one month, etc.). In this example, two rating-downgrade scenarios of different severity are used, along with a scenario built on low-earnings projections and a potential reputational-risk scenario.

Exhibit 4 shows an alternative format for summarizing the results of multiple scenarios. In this case, summary funding gaps are presented across various time horizons (columns) for each scenario (rows). Actual reports used should be tailored to the specific liquidity-risk profile and other institution-specific characteristics.

III. Liquidity Characteristics of Assets, Liabilities, Off-Balance-Sheet Positions, and Various Types of Banking Activities

A full understanding of the liquidity and cash-flow characteristics of the institution's assets, liabilities, OBS items, and banking activities is critical to the identification and management of mismatch risk, contingent liquidity risk, and market liquidity risk. This understanding is required for constructing meaningful cash-flow-projection worksheets under alternative scenarios, for developing and executing strategies used in managing mismatches, and for customizing summary liquidity measures or ratios.

A. Assets

The generation of assets is one of the primary uses of funds at banking organizations. Once acquired, assets provide cash inflows through principal and interest payments. Moreover, the liquidation of assets or their use as collateral for borrowing purposes makes them an important source of funds and, therefore, an integral tool in managing liquidity risk. As a result, the objectives underlying an institution's holdings of various types of assets range along a continuum that balances the tradeoffs between maximizing risk-adjusted returns and ensuring the fulfillment of an institution's contractual obligations to deliver funds (ultimately in the form of cash). Assets vary by structure, maturity, credit quality, marketability, and other characteristics that generally reflect their relative ability to be convertible into cash.

Cash operating accounts that include vault cash, cash items in process, correspondent accounts, accounts with the Federal Reserve, and other cash or "near-cash" instruments are the primary tools institutions use to execute their immediate cash-transaction obligations. They are generally not regarded as sources of additional or incremental liquidity but act as the operating levels of cash necessary for executing day-to-day transactions. Accordingly, well-managed institutions maintain ongoing balances in such accounts to meet daily business transactions. Because they generate no or very low interest earnings, such holdings are generally maintained at the minimum levels necessary to meet day-to-day transaction needs.

Exhibit 3—Example Summary Contingent-Liquidity-Exposure Report (for an Assumed Time Horizon)

Events:	*Current*	*Ratings downgrade*		*Earnings*	*Reputation*	*Other (?)*
Scenarios:		*1 category*	*BBB to BB*	*RoA = ?*		
Potential funding erosion						
Large fund providers	___	___	___	___	___	___
Fed funds	___	___	___	___	___	___
CDs	___	___	___	___	___	___
Eurotakings/foreign deposits	___	___	___	___	___	___
Commercial paper	___	___	___	___	___	___
Subtotal	___	___	___	___	___	___
Other funds providers						
Fed funds	___	___	___	___	___	___
CDs	___	___	___	___	___	___
Eurotakings/foreign deposits	___	___	___	___	___	___
Commercial paper	___	___	___	___	___	___
DDAs	___	___	___	___	___	___
Consumer						
MMDAs	___	___	___	___	___	___
Savings	___	___	___	___	___	___
Other	___	___	___	___	___	___
Total uninsured funds	___	___	___	___	___	___
Total insured funds	___	___	___	___	___	___
Total funding	___	___	___	___	___	___
Off-balance-sheet needs						
Letters of credit	___	___	___	___	___	___
Loan commitments	___	___	___	___	___	___
Securitizations	___	___	___	___	___	___
Derivatives	___	___	___	___	___	___
Total OBS items	___	___	___	___	___	___
Total funding erosion	___	___	___	___	___	___
Sources of funds						
Surplus money market	___	___	___	___	___	___
Unpledged securities	___	___	___	___	___	___
Securitizations						
Credit cards	___	___	___	___	___	___
Autos	___	___	___	___	___	___
Mortgages	___	___	___	___	___	___
Loan sales	___	___	___	___	___	___
Other	___	___	___	___	___	___
Total internal sources	___	___	___	___	___	___
Borrowing capacity	___	___	___	___	___	___
Brokered-funds capacity	___	___	___	___	___	___
Fed discount borrowings	___	___	___	___	___	___
Other	___	___	___	___	___	___

Exhibit 4—Example Summary Contingent-Liquidity-Exposure Report (Across Various Time Horizons)

		Projected liquidity cushion			
	1 week	2–4 weeks	2 months	3 months	4+ months
Normal course of business					
Total cash inflows	___	___	___	___	___
Total cash outflows	___	___	___	___	___
Liquidity cushion (shortfall)	___	___	___	___	___
Liquidity coverage ratio	___	___	___	___	___
Mild institution-specific					
Total cash inflows	___	___	___	___	___
Total cash outflows	___	___	___	___	___
Liquidity cushion (shortfall)	___	___	___	___	___
Liquidity coverage ratio	___	___	___	___	___
Severe institution-specific					
Total cash inflows	___	___	___	___	___
Total cash outflows	___	___	___	___	___
Liquidity cushion (shortfall)	___	___	___	___	___
Liquidity coverage ratio	___	___	___	___	___
Severe credit crunch					
Total cash inflows	___	___	___	___	___
Total cash outflows	___	___	___	___	___
Liquidity cushion (shortfall)	___	___	___	___	___
Liquidity coverage ratio	___	___	___	___	___
Capital-markets disruption					
Total cash inflows	___	___	___	___	___
Total cash outflows	___	___	___	___	___
Liquidity cushion (shortfall)	___	___	___	___	___
Liquidity coverage ratio	___	___	___	___	___
Custom scenario					
Total cash inflows	___	___	___	___	___
Total cash outflows	___	___	___	___	___
Liquidity cushion (shortfall)	___	___	___	___	___
Liquidity coverage ratio	___	___	___	___	___

Beyond cash and near-cash instruments, the extent to which assets contribute to an institution's liquidity profile and the management of liquidity risk depends heavily on the contractual and structural features that determine an asset's cash-flow profile, its marketability, and its ability to be pledged to secure borrowings. The following sections discuss important aspects of these asset characteristics that effective managers factor into their management of liquidity risk on an ongoing basis and during adverse liquidity events.

Structural cash-flow attributes of assets. Knowledge and understanding of the contractual and structural features of assets, such as their maturity, interest and amortization payment schedules, and any options (either explicit or embedded) that might affect contractual cash flows under alternative scenarios, is critical for the adequate measurement and management of liquidity risk. Clearly, the maturity of assets is a key input in cash-flow analysis. Indeed, the management of asset maturities is a critical tool used in matching expected cash outflows and inflows. This matching is generally accomplished by "laddering" asset maturities in order to meet scheduled cash needs out through short and intermediate time horizons.

Short-term money market assets (MMAs) are the primary "laddering" tools used to meet funding gaps over short-term time horizons. They provide vehicles for institutions to ensure future cash availability while earning a return. Given the relatively low return on such assets, managers face important tradeoffs between earnings and the provision of liquidity in deploying such assets. In general, larger institutions employ a variety of MMAs in making such tradeoffs, while smaller community organizations face fewer potential sources of short-term investments.

The contractual and structural features, such as the maturity and payment streams of all financial assets, should be factored into both cash-flow projections and the strategies developed for filling negative funding gaps. This practice includes the assessment of embedded options in assets that can materially affect an asset's cash flow. Effective liquidity managers incorporate the expected exercise of options in projecting cash flows for the various scenarios they use in measuring liquidity risk. For example, normal "business as usual" projections may include an estimate of the expected amount of loan and security principal prepayments under prevailing market interest rates, while alternative-scenario projections may employ estimates of expected increases in prepayments (and cash flows) arising from declining interest rates and expected declines in prepayments or "maturity extensions" resulting from rising market interest rates.

Market liquidity, or the "marketability" of assets. Marketability is the ability to convert an asset into cash through a quick "sale" and at a fair price. This ability is determined by the market in which the sale transaction is conducted. In general, investment-grade securities are more marketable than loans or other assets. Institutions generally view holdings of investment securities as a first line of defense for contingency purposes, but banks need to fully assess the marketability of these holdings. The availability and size of a bid-asked spread for an asset provides a general indication of the market liquidity of that asset. The narrower the spread, and the deeper and more liquid the market, the more likely a seller will find a willing buyer at or near the asked price. Importantly, however, the market liquidity of an asset is not a static attribute but is a function of conditions prevailing in the secondary markets for the particular asset. Bid-asked spreads, when they exist, generally vary with the volume and frequency of transactions in the particular type of assets. Larger volumes and greater frequency of transactions are generally associated with narrower bid-asked spreads. However, disruptions in the marketplace, contractions in the number of market makers, the execution of large block transactions in the asset, and other market factors may result in the widening of the bid-asked spread—and thus reduce the market liquidity of an instrument. Large transactions, in particular, can constrain the market liquidity of an asset, especially if the market for the asset is not deep.

The marketability of assets may also be constrained by the volatility of overall market prices and the underlying rates, which may cause widening bid-asked spreads on marketable assets. Some assets may be more subject to this type of market volatility than others. For example, securities that have inherent credit or interest-rate risk can become more difficult to trade during times when market participants have a low tolerance for these risks. This may be the case when market uncertainties prompt investors to shun risky securities in favor of more-stable investments, resulting in a so-called flight to quality. In a flight to quality, investors become much more willing to sacrifice yield in exchange for safety and liquidity.

In addition to reacting to prevailing market conditions, the market liquidity of an asset can be affected by other factors specific to individual investment positions. Small pieces of security issues, security issues from nonrated and obscure issuers, and other inactively traded securities may not be as liquid as other investments. While brokers and dealers buy and sell inactive securities, price quotations may not be readily available, or when they are, bid-asked spreads may be relatively wide. Bids for such securities are unlikely to be as high as the bids for similar but actively traded securities. Therefore, even though sparsely traded securities can almost always be sold, an unattractive price can make the seller unenthusiastic about selling or result in potential losses in order to raise cash through the sale of an asset.

Accounting conventions can also affect the market liquidity of assets. For example, Accounting Standards Codification (ASC) 320, "Investments—Debt and Equity Securities," (or

Statement of Financial Accounting Standards No. 115 (FAS 115)) requires investment securities to be categorized as held-to-maturity (HTM), available-for-sale (AFS), or trading, significantly affects the liquidity characteristics of investment holdings. Of the three categories, securities categorized as HTM provide the least liquidity, as they cannot be sold to meet liquidity needs without potentially onerous repercussions.[7]

Securities categorized as AFS can be sold at any time to meet liquidity needs, but care must be taken to avoid large swings in earnings or triggering impairment recognition of securities with unrealized losses.

Trading account securities are generally considered the most marketable from an accounting standpoint, since selling a trading account investment has little or no income effect.

While securities are generally considered to have greater market liquidity than loans and other assets, liquidity-risk managers increasingly consider the ability to obtain cash from the sale of loans as a potential source of liquidity. Many types of bank loans can be sold, securitized, or pledged as collateral for borrowings. For example, the portions of loans that are insured or guaranteed by the U.S. government or by U.S. government–sponsored enterprises are readily saleable under most market conditions. From a market liquidity perspective, the primary difference between loans and securities is that the process of turning loans into cash can be less efficient and more time-consuming. While securitizations of loan portfolios (discussed below) are more common in practice, commercial loans and portfolios of mortgages or retail loans can be, and often are, bought and sold by banking organizations. However, the due diligence and other requirements of these transactions generally take weeks or even months to complete, depending on the size and complexity of the loans being sold. Liquidity-risk managers may include selling marketable loans as a potential source of cash in their liquidity analyses, but they must be careful to realistically time the expected receipt of cash and should carefully consider past experience and market conditions at the expected time of sale. Institutions that do not have prior experience selling a loan or a mortgage portfolio often need more time to close a loan sale than does an institution that makes such transactions regularly. Additionally, in systemic liquidity or institution-specific credit-quality stress scenarios, the ability to sell loans outright may not be a realistic assumption.

Securitization can be a valuable method for converting otherwise illiquid assets into cash. Advances in the capital markets have made residential mortgage, credit card, student, home equity, automobile, and other loan types increasingly amenable to securitization. As a result, the securitization of loans has become an important funds-management tool at many depository institutions. Many institutions have business lines that originate assets specifically for securitization in the capital markets. However, while securitization can play an important role in managing liquidity, it can also increase liquidity risk—especially when excessive reliance is placed on securitization as a single source of funding.

Securitization can be regarded as an ongoing, reliable source of liquidity only for institutions that have experience in securitizing the specific type of loans under consideration. The time and effort involved in structuring loan securitizations make them difficult to use as a source of asset liquidity for institutions that have limited experience with this activity. Moreover, peculiarities involved in the structures used to securitize certain types of assets may introduce added complexity in managing an institution's cash flows. For example, the securitization of certain retail-credit receivables requires planning for the possible return of receivable balances arising from scheduled or early amortization, which may entail the funding of sizable balances at unexpected or inopportune times. Institutions using securitization as a source of funding should have adequate monitoring systems and ensure that such activities are fully incorporated into all aspects of their liquidity-risk management processes—which includes assessing the liquidity impact of securitizations under adverse scenarios. This assessment is especially important for institutions that originate assets specifically for securitization since market disruptions have the potential to impose the need for significant contingent liquidity if securitizations cannot be executed. As a result, effective liquidity managers ensure that the implications of securitization activities are fully considered in both their day-to-day liquidity management and their liquidity contingency planning.

7. HTM securities can be pledged, however, so they do still provide a potential source of liquidity. Furthermore, since the HTM-sale restriction is only an accounting standard (FAS 115)—not a market limitation—HTM securities can be sold in cases of extreme need.

Pledging of assets to secure borrowings. The potential to pledge securities, loans, or other assets to obtain funds is another important tool for converting assets into cash to meet funding needs. Since the market liquidity of assets is a significant concern to the lender of secured funds, assets with greater market liquidity are more easily pledged than less marketable assets. An institution that has a largely unpledged investment-securities portfolio has access to liquidity either through selling the investments outright or through pledging the investments as collateral for borrowings or public deposits. However, once pledged, assets are generally unavailable for supplying contingent liquidity through their sale. When preparing cash-flow projections, liquidity-risk managers do not classify pledged assets as "liquid assets" that can be sold to generate cash since the liquidity available from these assets has already been "consumed" by the institution. Accordingly, when computing liquidity measures, effective liquidity managers avoid double-counting unpledged securities as both a source of cash from the potential sale of the asset and as a source of new liabilities from the potential collateralization of the same security. In more-sophisticated cash-flow projections, the tying of the pledged asset to the funding is made explicit.

Similar to the pledging of securities, many investments can be sold under an agreement to repurchase. This agreement provides the institution with temporary cash without having to sell the investment outright and avoids the potential earnings volatility and transaction costs that buying and selling securities would entail.

Use of haircuts in measuring the funds that can be raised through asset sales, securitizations, or repurchase agreements. The planned use of asset sales, asset securitizations, or collateralized borrowings to meet liquidity needs necessarily involves some estimation of the value of the asset at the future point in time when the asset is anticipated to be converted into cash. Based on changes in market factors, future asset values may be more or less than current values. As a result, liquidity managers generally apply discounts, or *haircuts,* to the current value of assets to represent a conservative estimate of the anticipated proceeds available from asset sales or securitization in the capital markets. Similarly, lenders in secured borrowings also apply haircuts to determine the amount to lend against pledged collateral as protection if the value of that collateral declines. In this case, the haircut represents, in addition to other factors, the portion of asset value that cannot be converted to cash because secured lenders wish to have a collateral-protection margin.

When computing cash-flow projections under alternative scenarios and developing plans to meet cash shortfalls, liquidity managers ensure that they incorporate haircuts in order to reflect the market liquidity of their assets. Such haircuts are applied consistent with both the relative market liquidity of the assets and the specific scenario utilized. In general, longer-term, riskier assets, as well as assets with less liquid markets, are assigned larger haircuts than are shorter-term, less risky assets. For example, within the securities portfolio, different haircuts might be assigned to short-term and long-term Treasuries, rated and unrated municipal bonds, and different types of mortgage securities (e.g., pass-throughs versus CMOs). When available and appropriate, historical price changes over specified time horizons equal to the time until anticipated liquidation or the term of a borrowing are used by liquidity-risk managers to establish such haircuts. Haircuts used by nationally recognized statistical ratings organizations (NRSROs) are a starting point for such calculations but should not be unduly relied on since institution- and scenario-specific considerations may have important implications.

Haircuts should be customized to the particular projected or planned scenario. For example, adverse scenarios that hypothesize a capital-markets disruption would be expected to use larger haircuts than those used in projections assuming normal markets. Under institution-specific, adverse scenarios, certain assets, such as loans anticipated for sale, securitization, or pledging, may merit higher haircuts than those used under normal business scenarios. Institutions should fully document the haircuts they use to estimate the marketability of their assets.

Bank-owned life insurance (BOLI) is a popular instrument offering tax benefits as well as life insurance on bank employees. Some BOLI policies are structured to provide liquidity; however, most BOLI policies only generate cash in the event of a covered person's death and impose substantial fees if redeemed. In general, BOLI should not be considered a liquid asset. If it is included as a potential source of funds in a cash-flow analysis, a severe haircut reflecting the terms of the BOLI contract and current market conditions should be applied.

Liquid assets and liquidity reserves. Sound practices for managing liquidity risk call for institutions to maintain an adequate reserve of liquid assets to meet both normal and adverse liquidity situations. Such reserves should be structured consistent with the considerations discussed above regarding the marketability of different types of assets. Many institutions identify a specific portion of their investment account to serve as a liquidity reserve, or *liquidity warehouse*. The size of liquidity reserves should be based on the institution's assessments of its liquidity-risk profile and potential liquidity needs under alternative scenarios, giving full consideration to the costs of maintaining those assets. In general, the amount of liquid assets held will be a function of the stability of the institution's funding structures and the potential for rapid loan growth. If the sources of funds are stable, if adverse-scenario cash-flow projections indicate adequate sources of contingent liquidity (including sufficient sources of unused borrowing capacity), and if asset growth is predictable, then a relatively low asset liquidity reserve may be required. The availability of the liquidity reserves should be tested from time to time. Of course, liquidity reserves should be actively managed to reflect the liquidity-risk profile of the institution and current trends that might have a negative impact on the institution's liquidity, such as—

- trading market, national, or financial market trends that might lead rate-sensitive customers to pursue investment alternatives away from the institution;
- significant actual or planned growth in assets;
- trends evidencing a reduction in large liability accounts;
- a substantial portion of liabilities from rate-sensitive and credit-quality-sensitive customers;
- significant liability concentrations by product type or by large deposit account holders;
- a loan portfolio consisting of illiquid, nonmarketable, or unpledgeable loans;
- expectations for substantial draws on loan commitments by customers;
- significant loan concentrations by product, industry, customer, and location;
- significant portions of assets pledged against wholesale borrowings; and
- impaired access to the capital markets.

B. Liabilities

Similar to its assets, a depository institution's liabilities present a complicated array of liquidity characteristics. Banking organizations obtain funds from a wide variety of sources using an array of financial instruments. The primary characteristics that determine a liability's liquidity-risk profile include its term, optionality, and counterparty risk tolerance (which includes the counterparty's need for insurance or collateral). These features help to determine if an individual liability can be considered as stable or volatile. A stable liability is a reliable source of funds that is likely to remain available in adverse circumstances. A volatile liability is a less stable source of funds that may disappear or be unavailable to the institution under heavy price competition, deteriorating credit or market- risk conditions, and other possible adverse events. Developing assumptions on the relative stability or volatility of liabilities is a crucial step in forecasting a bank's future cash flows under various scenarios and in constructing various summary liquidity measures. As a result, effective liquidity managers segment their liabilities into volatile and stable components on the basis of the characteristics of the liability and on the risk tolerance of the counterparty. These funds may be characterized as credit-sensitive, rate-sensitive, or both.

Characteristics of stability and risk tolerance. The stability of an individual bank liability is closely related to the customer's or counterparty's risk tolerance, or its willingness and ability to lend or deposit money for a given risk and reward. Several factors affect the stability and risk tolerance of funds providers, including the fiduciary responsibilities and obligations of funds providers to their customers, the availability of insurance on the funds advanced by customers to banking organizations, the reliance of customers on public debt ratings, and the relationships funds providers have with the institution.

Institutional providers of funds to banking organizations, such as money market funds, mutual funds, trust funds, public entities, and other types of investment managers, have fiduciary obligations and responsibilities to adequately assess and monitor the relative risk-and-reward tradeoffs of the investments they make for their customers, participants, or constituencies. These fund providers are especially sensitive to receiving higher returns for higher risk, and they are more apt to withdraw funds if they sense that an institution has a deteriorating financial condition. In general, funds from sources that lend or deposit money on behalf of others are less stable than funds from sources that lend their own funds. For example, a mutual fund purchaser of an institution's negotiable CD may be expected to be less stable than a local customer buying the same CD.

Institutionally placed funds and other funds providers often depend on the published evaluations or ratings of NRSROs. Indeed, many such funds providers may have bylaws or internal guidelines that prohibit placing funds with institutions that have low ratings or, in the absence of actual guidelines, may simply be averse to retaining funds at an institution whose rating is poor or whose financial condition shows deterioration. As a result, funds provided by such investors can be highly unstable in adverse liquidity environments.

The availability of insurance on deposits or collateral on borrowed funds are also important considerations in gauging the stability of funds provided. Insured or collateralized funds are usually more stable than uninsured or unsecured funds since the funds provider ultimately relies on a third party or the value of collateral to protect its investment.

Clearly, the nature of a customer's relationship with an institution has significant implications for the potential stability or volatility of various sources of funds. Customers who have a long-standing relationship with an institution and a variety of accounts, or who otherwise use multiple banking services at the institution, are usually more stable than other types of customers.

Finally, the sensitivity of a funds provider to the rates paid on the specific instrument or transaction used by the banking organization to access funds is also critical for the appropriate assessment of the stability or volatility of funds. Customers that are very rate-driven are more likely not to advance funds or remove existing funds from an institution if more competitive rates are available elsewhere.

All of these factors should be analyzed for the more common types of depositors and funds providers and for the instruments they use to place funds with the institution. Such assessments lead to general conclusions regarding each type of customer's or counterparty's risk sensitivity and the stability of the funds provided by the instruments they use to place funds with the institution. Exhibit 5 provides a heuristic schematic of how effective liquidity-risk managers conduct such an assessment regarding the array of their different funds providers. It uses a continuum to indicate the general level of risk sensitivity (and thus the expected stability of funds) expected for each type of depositor, customer, or investor in an institution's debt obligations. Of course, individual customers and counterparties may have various degrees of such concerns, and greater granularity is generally required in practice. An additional instrument assessment of the stability or volatility of funds raised using that instrument from each type of fund provider is a logical next step in the process of evaluating the relative stability of various sources of funds to an institution.

There are a variety of methods used to assess the relative stability of funds providers. Effective liquidity managers generally review deposit accounts by counterparty type, e.g., consumer, small business, or municipality. For each type, an effective liquidity manager evaluates the applicability of risk or stability factors, such as whether the depositor has other relationships with the institution, whether the depositor owns the funds on deposit or is acting as an agent or manager, or whether the depositor is likely to be more aware of and concerned by adverse news reports. The depositors and counterparties considered to have a significant relationship with the institution and who are less sensitive to market interest rates can be viewed as providing *stable* funding. Statistical analysis of funds volatility is often used to separate total volumes into stable and nonstable segments. While such analysis can be very helpful, it is important to be mindful that historical volatility is unlikely to include a period of acute liquidity stress.

The following discussions identify important considerations that should be factored into the assessment of the relative stability of various sources of funds utilized by banking organizations.

Maturity of liabilities used to gather funds. An important factor in assessing the stability of funds sources is the remaining contractual life of the liability. Longer-maturity liabilities obvi-

Exhibit 5—General Characteristics of Stable and Volatile Liabilities

	Characteristics of funds providers that affect the stability/volatility of the funds provided				
Types of funds providers	*Fiduciary agent or own funds*	*Insured or secured*	*Reliance on public information*	*Relationship*	*Stability assessment*
Consumers	owner	yes	low	high	high
Small business	owner	in part	low	high	medium
Large corporate	owner	no	medium	medium	low
Banks	agent	no	high	medium	medium
Municipalities	agent	in part	high	medium	medium
Money market mutual funds	quasi-fiduciary	no	high	low	low
Other	___	___	___	___	___

ously provide more-stable funding than do shorter maturities. Extending liability maturities to reduce liquidity risk is a common management technique and an important sound practice used by most depository institutions. It is also a major part of the cost of liquidity management, since longer-term liabilities generally require higher interest rates than are required for similar short-term liabilities.

Indeterminate maturity deposits. Evaluations of the stability of deposits with indeterminate maturities, such as various types of transaction accounts (e.g., demand deposits, negotiable order of withdrawal accounts (NOWs) or money market demand accounts (MMDAs), and savings accounts) can be made using criteria similar to those shown in exhibit 5. In doing so, effective liquidity managers recognize that the relative stability or volatility of these accounts derives from the underlying characteristics of the customers that use them and not on the account type itself. As a result, most institutions delineate the relative volatility or stability of various subgroups of these account types on the basis of customer characteristics. For example, MMDA deposits of customers who have fiduciary obligations may be less stable than those of individual retail customers. Additionally, funds acquired through a higher pricing strategy for these types of deposit accounts are generally less stable than are deposits from customers who have long-standing relationships with the institution. Increasingly, liquidity managers recognize that traditional measures of "core" deposits may be inappropriate, and thus these deposits require more in-depth analysis to determine their relative stability.

Assessment of the relative stability or volatility of deposits that have indeterminate maturities can be qualitative as well as quantitative, consistent with the size, complexity, and sophistication of the institution. For example, at larger institutions, models based on statistical analysis can be used to estimate the stability of various subsets of such funds under alternative liquidity environments. Such models can be used to formulate expected behaviors in reaction to rate changes and other more-typical financial events. As they do when using models to manage any type of risk, institutions should fully document and understand the assumptions and methodologies used. This is especially the case when external parties conduct such analysis. Effective liquidity managers aggressively avoid "black-box" estimates of funding behaviors.

In most cases, insured deposits from consumers may be less likely to leave the institution under many liquidity circumstances than are funds supplied by more-institutional funds providers. Absent extenuating circumstances (e.g., the deposit contract prohibits early withdrawal), funds provided by agents and fiduciaries are generally treated by banking organizations as volatile liabilities.

Certificates of deposit and time deposits. At maturity, certificates of deposit (CDs) and time deposits are subject to the general factors regarding stability and volatility discussed above, including rate sensitivity and relationship factors. Nonrelationship and highly-rate-sensitive deposits tend to be less stable than deposits placed by less-rate-sensitive customers who have close relationships with the institution. Insured CDs are generally considered more stable than uninsured "jumbo" CDs in denominations of more than $100,000. In general, jumbo CDs and negotiable CDs are more volatile sources of funds—especially during times of stress—since they may be less relationship-driven and have a higher sensitivity to potential credit problems.

Brokered deposits and other rate-sensitive deposits. Brokered deposits are funds a bank obtains, directly or indirectly, by or through any deposit broker, for deposit into one or more accounts. 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. Rates paid on brokered deposits are often higher than those paid for local-market-area retail deposits since brokered-deposit customers are generally focused on obtaining the highest FDIC-insured rate available. These rate-sensitive customers have easy access to, and are frequently well informed about, alternative markets and investments, and they may have no other relationship with or loyalty to the bank. If market conditions change or more-attractive returns become available, these customers may rapidly transfer their funds to new institutions or investments. Accordingly, these rate-sensitive depositors may exhibit characteristics more typical of wholesale investors, and liquidity-risk managers should model brokered deposits accordingly.

The use of brokered deposits is governed by law and covered by the 2001 Joint Agency Advisory on Brokered and Rate-Sensitive Deposits.[8] Under 12 USC 1831f and 12 CFR 337.6, determination of "brokered" status is based initially on whether a bank actually obtains a deposit directly or indirectly through a deposit broker. Banks that are considered only "adequately capitalized" under the "prompt corrective action" (PCA) standard must receive a waiver from the FDIC before they can accept, renew, or roll over any brokered deposit. They are also restricted in the rates they may offer on such deposits. Banks falling below the adequately capitalized range may not accept, renew, or roll over any brokered deposit, nor solicit deposits with an effective yield more than 75 basis points above the "national rate." The national rate is defined as "a simple average of rates paid by all insured depository institutions and branches for which data are available." On a weekly basis, the "national rate" is posted on the FDIC's website. If a depository institution believes that the "national rate" does not correspond to the actual prevailing rate in the applicable market, the institution may seek a determination from the FDIC that the institution is operating in a "high-rate area." If the FDIC makes such a determination, the bank will be allowed to offer the actual prevailing rate plus 75 basis points. In any event, for deposits accepted outside the applicable market area, the bank will not be allowed to offer rates in excess of the "national rate" plus 75 basis points.

These restrictions will reduce the availability of funding alternatives as a bank's condition deteriorates. The FDIC is not authorized to grant waivers for banks that are less than adequately capitalized. Bank managers who use brokered deposits should be familiar with the regulations governing brokered deposits and understand the requirements for requesting a waiver. Further detailed information regarding brokered deposits can be found in the FDIC's Financial Institution Letter (FIL), 69-2009.

Deposits attracted over the Internet, through CD listing services, or through special advertising programs that offer premium rates to customers who do not have another banking relationship with the institution also 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 may be similar to those of 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 in times of stress.

Under the 2001 joint agency advisory, banks are expected to perform adequate due diligence before entering any business relationship with a deposit broker; assess the potential risks to earnings and capital associated with brokered deposits; and fully incorporate the assessment

8. Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision. May 11, 2001. See SR-01-14.

and control of brokered deposits into all elements of their liquidity-risk management processes, including CFPs.

Public or government deposits. Public funds generally represent deposits of the U.S. government, state governments, and local political subdivisions; they typically require collateral to be pledged against them in the form of securities. In most banks, deposits from the U.S. government represent a much smaller portion of total public funds than that of funds obtained from states and local political subdivisions. Liquidity-risk managers generally consider the secured nature of these deposits as being a double-edged sword. On the one hand, they reduce contingent liquidity risk because secured funds providers are less credit-sensitive, and therefore their deposits may be more stable than those of unsecured funds providers. On the other hand, such deposits reduce standby liquidity by "consuming" the potential liquidity in the pledged collateral.

Rather than pledge assets as collateral for public deposits, banks may also purchase an insurance company's surety bond as coverage for public funds in excess of FDIC insurance limits. Here, the bank would not pledge assets to secure deposits, and the purchase of surety bonds would not affect the availability of funds to all depositors in the event of insolvency. The costs associated with the purchase of a surety bond must be taken into consideration when using this alternative.

Deposits from taxing authorities (most school districts and municipalities) also tend to be highly seasonal. The volume of public funds rises around tax due dates and falls near the end of the period before the next tax due date. This fluctuation is clearly a consideration for liquidity managers projecting cash flows for normal operations. State and local governments tend to be very rate-sensitive. Effective liquidity managers fully consider the contingent liquidity risk these deposits entail, that is, the risk that the deposits will not be maintained, renewed, or replaced unless the bank is willing to offer very competitive rates.

Eurodollar deposits. Eurodollar time deposits are certificates of deposit issued by banks outside of the United States. Large, internationally active U.S. banks may obtain Eurodollar funding through their foreign branches—including offshore branches in the Cayman Islands or other similar locales. Eurodollar deposits are usually negotiable CDs issued in amounts of $100,000 or more, with rates tied to LIBOR. Because they are negotiable, the considerations applicable to negotiable CDs set forth above also apply to Eurodollar deposits.

Federal funds purchased. Federal funds (fed funds) are excess reserves held at Federal Reserve Banks. The most common type of federal funds transaction is an overnight, unsecured loan. Transactions that are for a period longer than one day are called *term fed funds.* The day-to-day use of fed funds is a common occurrence, and fed funds are considered an important money market instrument used in managing daily liquidity needs and sources.

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. Overnight fed funds purchased can pose a contingent liquidity risk, particularly if a bank is unable to roll over or replace the maturing borrowing under stress conditions. Term fed funds pose almost the same risk since the term is usually just a week or two. Fed funds purchased should generally be treated as a volatile source of funds.

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. Correspondent banks are usually moderately credit-sensitive. Accordingly, cash-flow projections for normal business conditions and mild adverse scenarios may often treat these funds as stable. However, given the credit sensitivity of such funds, projections computed for severe adverse liquidity scenarios should treat these funds as volatile.

FHLB borrowings. The Federal Home Loan Banks (FHLBs) provide loans, referred to as *advances,* to members. Advances must be secured by collateral acceptable to the FHLB, such as residential mortgage loans and mortgage-backed securities. Both short-term and long-term FHLB borrowings, with maturities ranging from overnight to 10 years, are available to member institutions at generally competitive interest rates. For some small and medium-sized banks, long-term FHLB advances may be a significant or the only source of long-term funding.

It should be noted that FHLBs may also sell their excess cash into the market in the form of fed funds. This is a transaction where the FHLB is managing its excess funding and has chosen to invest that excess in short-term unsecured fed funds. This transaction is executed through the capital markets and is not done with specific members of the FHLB.

Some FHLB advances contain embedded options or other features that may increase funding risk. For example, some types of advances, such as putable and convertible advances, provide the FHLB with the option to either recall the advance or change the interest rate on an advance from a fixed rate to a floating rate under specified conditions. When such optionality exists, institutions should fully assess the implications of this optionality on the liquidity-risk profile of the institution.

In general, an FHLB establishes a line of credit for each of its members. Members are required to purchase FHLB stock before a line of credit is established, and the FHLB has the ability to restrict the redemption of its stock. An FHLB may also limit or deny a member's request for an advance if the member engages in any unsafe or unsound practice, is inadequately capitalized, sustains operating losses, is deficient with respect to financial or managerial resources, or is otherwise deficient.

Because FHLB advances are secured by collateral, the unused FHLB borrowing capacity of a bank is a function of both its eligible, unpledged collateral and its unused line of credit with its FHLB.

FHLBs have access to bank regulatory information not available to other lenders. The composite rating of an institution is a factor in the approval for obtaining an FHLB advance, as well as the level of collateral required and the continuance of line availability. Because of this access to regulatory data, an FHLB can react quickly to reduce its exposure to a troubled institution by exercising options or not rolling over unsecured lines of credit. Depending on the severity of a troubled institution's condition, an FHLB has the right to increase collateral requirements or to discontinue or withdraw (at maturity) its collateralized funding program because of concerns about the quality or reliability of the collateral or other credit-related concerns. On the one hand, this right may create liquidity problems for an institution, especially if it has large amounts of short-term FHLB funding. At the same time, because FHLB advances are fully collateralized, the various FHLBs have historically worked with regulators prior to exercising their option to fully withdraw funding from members. To this extent, FHLB borrowings are viewed by many liquidity managers as a relatively stable source of funding, barring the most severe of adverse funding situations.

Sound liquidity-risk management practices call for institutions to fully document the purpose of any FHLB-borrowing transaction. Each transaction should be analyzed on an ongoing basis to determine whether the arrangement achieves the stated purpose or whether the borrowings are a sign of liquidity deficiencies. Some banks may use their FHLB line of credit to secure public funds; however, doing so will reduce their available funds and may present problems if the FHLB reduces the institution's credit line. Additionally, the institution should periodically review its borrowing agreement with the FHLB to determine the assets 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.

Repurchase agreements and dollar rolls. The terms *repurchase agreement*[9] (repo) and *reverse repurchase agreement* refer to transactions in which a bank acquires 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. A transaction is considered 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).

A repo commonly has a near-term maturity (overnight or a few days) with tenors rarely exceeding three months. Repos are also usually arranged in large dollar amounts. Repos may be used to temporarily finance the purchase of securities and dealer securities inventories. Banking organizations also use repos as a substitute for direct borrowings. Bank securities holdings as well as loans are often sold under repurchase agreements to generate temporary working funds. These types of agreements are often used because the rate on this

9. See section 3010.1.

type of borrowing is less than the rate on unsecured borrowings, such as federal funds purchased.

U.S. government and agency securities are the most common type of instruments sold under repurchase agreements, since they are exempt from reserve requirements. However, 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 transactions are often referred to as *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. To qualify as a financing, these agreements require the return of "substantially similar securities" and cannot exceed 12 months from the initiation of the transaction. The dollar-roll market primarily consists of agreements that involve mortgage-backed securities.

Another common repo arrangement is called an *open repo*, which provides a flexible term to maturity. An open 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.

Effective liquidity-risk managers ensure that they are aware of special considerations and potential risks of repurchase agreements, especially when the bank enters into large-dollar-volume transactions with institutional investors or brokers. It is a fairly common practice to adjust the collateral value of the underlying securities daily to reflect changes in market prices and to maintain the agreed-on margin. Accordingly, if the market value of the repo-ed 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 increase if the securities were physically transferred to the institution or broker with which the bank has entered into the repurchase agreement.

Because these instruments are usually very short-term transactions, institutions using them incur contingent liquidity risk. Accordingly, cash-flow projections for normal and mild scenarios usually treat these funds as stable. However, projections computed for severe scenarios generally treat these funds as volatile.

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 accounts (due from foreign bank 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. In general, these borrowings are often considered to be highly volatile, nonstable sources of funds.

Federal Reserve Bank borrowings. In 2003, the Federal Reserve Board revised Regulation A to provide for primary and secondary credit programs at the discount window.[10] (See section 4025.1.) Reserve Banks will extend primary credit at a rate above the target fed funds rate on a short-term basis (typically, overnight) to eligible depository institutions, and acceptable collateral is required to secure all obligations. Discount window borrowings can be secured with an array of collateral, including consumer and commercial loans. Eligibility for primary credit is based largely on an institution's examination rating and capital status. In general, institutions with composite CAMELS ratings of 1, 2, or 3 that are at least adequately capitalized are eligible for primary credit unless supplementary information indicates their condition is not generally sound. Other conditions exist to determine eligibility for 4- and 5-rated institutions.

An institution eligible for primary credit need not exhaust other sources of funds before coming to the discount window. However, because

10. See the "Interagency Advisory on the Use of the Federal Reserve's Primary Credit Program in Effective Liquidity Management," Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, and Office of Thrift Supervision, July 25, 2003, and SR-03-15. See also section 3010.1.

of the above-market price of primary credit, the Reserve Banks expect institutions to mainly use the discount window as a backup source of liquidity rather than as a routine source. Generally, Reserve Banks extend primary credit on an overnight basis with minimal administrative requirements to eligible institutions. Reserve Banks may also extend primary credit to eligible institutions for periods of up to several weeks if funding is not available from other sources. These longer extensions of credit are subject to greater administrative oversight. Reserve Banks also offer secondary credit to institutions that do not qualify for primary credit. Secondary credit is another short-term backup source of liquidity, although its availability is more limited and is generally used for emergency backup purposes. Reserve Banks extend secondary credit to assist in an institution's timely return to a reliance on traditional funding sources or in the resolution of severe financial difficulties. This program entails a higher level of Reserve Bank administration and oversight than primary credit.

Treasury Tax and Loan deposits. Treasury Tax and Loan accounts (TT&L accounts) are maintained at banks by the U.S. Treasury to facilitate payments of federal withholding taxes. Banks may select either the "remittance-option" or the "note-option" method of forwarding deposited funds to the U.S. Treasury. In the remittance option, the bank remits the TT&L account deposits to the Federal Reserve Bank the next business day after deposit, and the remittance portion is not interest-bearing. The note option permits the bank to retain the TT&L deposits. In 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. Note-option accounts are interest-bearing and can grow to a substantial size.

TT&L funds are considered purchased funds, evidenced by an interest-bearing, variable-rate, open-ended, secured note callable on demand by Treasury. As per 31 CFR 203.24, the TT&L balance requires pledged collateral, usually from the bank's investment portfolio. Because they are secured, TT&L balances reduce standby liquidity from investments, and because they are callable, TT&L balances are considered to be volatile and they must be carefully monitored. However, in most banks, TT&L deposits constitute only a minor portion of total liabilities.

C. Off-Balance-Sheet Obligations

Off-balance-sheet transactions have been one of the fastest-growing areas of banking activity. While these activities may not be reflected on the balance sheet, they must be thoroughly reviewed in assessing an institution's liquidity-risk profile, as they can expose the institution to significant contingent liquidity risk. Effective liquidity-risk managers pay particular attention to potential liquidity risks in loan commitments, lines of credit, performance guarantees, and financial guarantees. Banks should estimate both the amount and the timing of potential cash flows from off-balance-sheet claims.

Effective liquidity managers ensure that they consider the correlation of draws on various types of commitments that can trend with macroeconomic conditions. For example, standby letters of credit issued in lieu of construction completion bonds are often drawn when builders cannot fulfill their contracts. Some types of credit lines, such as those used to provide working capital to businesses, are most heavily used when either the borrower's accounts receivable or inventory is accumulating faster than its collections of accounts payable or sales. Liquidity-risk managers should work with the appropriate lending managers to track such trends.

In addition, funding requirements arising from some types of commitments can be highly correlated with the counterparty's credit quality. Financial standby letters of credit (SBLOCs) are often used to back the counterparty's direct financial obligations, such as commercial paper, tax-exempt securities, or the margin requirements of securities and derivatives exchanges. At some institutions, a major portion of off-balance-sheet claims consists of SBLOCs supporting commercial paper. If the institution's customer issues commercial paper supported by an SBLOC and if the customer is unable to repay the commercial paper at maturity, the holder of the commercial paper will request that the institution perform under the SBLOC. Liquidity-risk managers should work with the appropriate lending manager to (1) monitor the credit grade or default probability of such counterparties and (2) manage the industry diversification of these commitments in order to reduce the probability that multiple counterparties will be forced to draw against the bank's commitments at the same time.

Funding under some types of commitments can also be highly correlated with changes in the institution's own financial condition or perceived credit quality. Commitments supporting various types of asset-backed securities, asset-backed commercial paper, and derivatives can be subject to such contingent liquidity risk. The securitization of assets generally requires some form of credit enhancement, which can take many forms, including SBLOCs or other types of guarantees issued by a bank. Similarly, many structures employ *special-purpose entities* (SPEs) that own the collateral securing the asset-backed paper. Bank SBLOCs or guarantees often support those SPEs. As long as the institution's credit quality remains above defined minimums, which are usually based on ratings from NRSROs, few or none of the SBLOCs will fund. However, if the institution's credit rating falls below the minimum, a significant amount or all of such commitments may fund at the same time.

Financial derivatives can also give rise to contingent liquidity risk arising from financial market disruptions and deteriorating credit quality of the banking organization. Derivatives contracts should be reviewed, and their potential for early termination should be assessed and quantified, to determine the adequacy of the institution's available liquidity. Many forms of standardized derivatives contracts allow counterparties to request collateral or to terminate contracts early if the institution experiences an adverse credit event or deterioration in its financial condition. In addition, under situations of market stress, a customer may ask for early termination of some contracts. In such circumstances, an institution that owes money on derivatives transactions may be required to deliver collateral or settle a contract early, when the institution is encountering additional funding and liquidity pressures. Early terminations may also create additional, unintended market exposures. Management and directors should be aware of these potential liquidity risks and address them in the institution's CFP. All off-balance-sheet commitments and obligations should receive the focused attention of liquidity-risk managers throughout the liquidity-risk management process.

D. Specialized Business Activities

Institutions that engage in specialized banking activities should ensure that all elements of these activities are fully incorporated into their assessment of liquidity-risk exposure and their ongoing management of the firm's liquidity. Such activities may include mortgage servicing, trading and dealer activities, and various types of fee-income-generating businesses.

Institutions engaged in significant payment, clearing, and settlement activities face particular challenges. Institutions that are active in payment, settlement, or clearing activities should ensure that they have mechanisms for measuring, monitoring, and identifying the amount of liquidity they may need to settle obligations in normal as well as stressed environments. These institutions should fully consider the unique risks that may result from their participation in different payment-system activities and factor these risks into their liquidity contingency planning. Factors that banks should consider when developing liquidity plans related to payment activities include—

- the impact of pay-in rules of individual payment systems, which may result in short-notice payment adjustments and the need to assess peak pay-in requirements that could result from the failure of another participant;
- the potential impact of operational disruptions at a payment utility and the potential need to move activity to another venue in which settlement is gross rather than net, thereby increasing liquidity requirements to settle;
- the impact that the deteriorating credit quality of the institution may have on collateral requirements, changes in intraday lending limits, and the institution's intraday funding needs; and
- for clearing and nostro service providers, the impact of potential funding needs that could be generated by their clearing customers in addition to the bank's own needs.

IV. Summary Measures of Liquidity-Risk Exposure

Cash-flow projections constructed assuming normal and adverse conditions provide a wealth of information about the liquidity profile of an institution. However, liquidity managers, bank supervisors, rating agencies, and other interested parties use a myriad of summary measures of liquidity to identify potential liquidity risk. These measures include various types of financial ratios. Many of these measures attempt to achieve some of the same insights provided by comprehensive cash-flow scenario analyses but use significantly less data. When calculated using standard definitions and comparable data, such measures provide the ability to track trends over time and facilitate comparisons across peers. At the same time, however, many summary measures necessarily entail simplifying assumptions regarding the liquidity of assets, the relative stability or volatility of liabilities, and the ability of the institution to meet potential funding needs. Supervisors, management, and other stakeholders that use these summary measures should fully understand the effect of these assumptions and the limitations associated with summary measures.

Although general industry conventions may be used to compute various summary measures, liquidity managers should ensure that the specific measures they use for internal purposes are suitably customized for their particular institution. Importantly, effective liquidity managers recognize that no single summary measure or ratio captures all of the available sources and uses of liquidity for all situations and for all time periods. Different ratios capture different facets of liquidity and liquidity risk. Moreover, the same summary measure or ratio calculated using different assumptions can also capture different facets of liquidity. This is an especially important point since, by definition, many liquidity ratios are scenario-specific. Measures constructed using normal-course-of-business assumptions can portray liquidity profiles that are significantly different from those constructed assuming stress contingency events. Indeed, many liquidity managers use the same summary measures and financial ratios computed under alternative scenarios and assumptions to evaluate and communicate to senior management and the board of directors the institution's liquidity-risk profile and the adequacy of its CFPs.

A. Cash-Flow Ratios

Cash-flow ratios are especially valuable summary liquidity measures. These measures summarize the information contained in detailed cash-flow projections and forecasts. They are generally constructed as the ratio of total projected cash inflows divided by total projected cash outflows for a particular time period or cash-flow-projection time bucket. The ratio for a given time bucket indicates the relative amount by which the projected sources of liquidity cover projected needs. For example, a ratio of 1.20 indicates a liquidity "surplus" equal to 20 percent of projected outflows. In general, such coverage ratios are compiled for each time bucket in the cash-flow projections used to assess both normal and adverse liquidity circumstances.

Some institutions also employ cumulative cash-flow ratios that are computed as the ratio of the cumulative sum of cash inflows to the cumulative sum of cash outflows for all time buckets up to a given time bucket. However, care should be taken to recognize that cumulative cash-flow ratios used alone and without the benefit of assessing the individual time-period exposures for each of their component time buckets may mask liquidity-risk exposures that can exist at intervals up to the cumulative time horizons chosen.

B. Other Summary Liquidity Measures

Other common summary liquidity measures employ assumptions about, and depend heavily on, the assessment and characterization of the relative marketability and liquidity of assets and the relative stability or volatility of funding needs and sources, consistent with the considerations discussed in the prior section. Liquidity managers use these other measures to review historical trends, summarize their projections of potential liquidity-risk exposures under adverse liquidity conditions, and develop strategies to address contingent liquidity events. In selecting from the myriad of available measures, effective liquidity managers focus primarily on those measures that are most related to the liquidity-management strategies pursued by the institution. For example, institutions that focus on managing asset liquidity place greater emphasis on measures that gauge such conditions, while institutions placing greater emphasis on managing liability liquidity emphasize measures that address those aspects of their liquidity-risk profile.

The following discussions briefly describe some of the more common summary measures of liquidity and liquidity risk. Some of these measures are employed by liquidity managers, rating agencies, and supervisors using definitions and calculation methods amenable to publicly available Call Report or BHC Performance Report data. Because such data require the use of assumptions on the liquidity of broad classes of assets and on the stability of various types of aggregated liabilities, liquidity managers and supervisors should take full advantage of the available granularity of internal data to customize the summary measures they are using. Incorporating internal data ensures that summary measures fit the specific liquidity profile of the institution. Such customization permits a more robust assessment of the institution's liquidity-risk profile.

In general, most common summary measures of liquidity and liquidity risk can be grouped into the following three broad categories:

1. those that portray the array of assets along a continuum of liquidity and cash-flow characteristics for normal and potentially adverse circumstances
2. those that portray the array of liabilities along a continuum of potential volatility and stability characteristics under normal and potentially adverse circumstances
3. those that assess the balance between funding needs and sources based on assumptions about both the relative liquidity of assets and the relative stability of liabilities

Relative liquidity of assets. Summary measures that address the liquidity of assets usually start with assessments of the maturity or type of assets in an effort to gauge their contributions to actual cash inflows over various time horizons. In general, they represent an attempt to summarize and characterize the expected cash inflows from assets that are estimated in more-detailed cash-flow-projection worksheets assuming normal business conditions. Summary measures assessing the liquidity of assets include such measures as—

- short-term investments (defined as maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of total investments, and
- short-term assets (defined as maturing within a specified time period) as a percent of total assets.

Other measures within this category attempt to assess the expected time period over which longer-term, illiquid assets may need to be funded. These measures, which use broad asset categories and employ strong assumptions on the liquidity of these assets, include—

- loans and leases as a percent of total assets, and
- long-term assets (defined as maturing beyond a specified time period) as a percent of total assets.

To better gauge the potential for assets to be used as sources of liquidity to meet uncertain future cash needs, effective liquidity managers use additional "liquid asset" summary measures that are customized to take into account the ability (or inability) to convert assets into cash or borrowed funds. Such measures attempt to summarize the potential for sale, securitization, or use as collateral of different types of assets, subject to appropriate scenario-specific haircuts. Such measures also attempt to recognize the constraints on potential securitization and on those assets that have already been pledged as collateral for existing borrowings. Examples of these measures include—

- marketable securities (as determined by the assessment of cash-flow, accounting, and haircut considerations discussed in the previous section) to total securities;
- marketable securities as a percent of total assets;
- marketable assets (as determined by the assessment of cash-flow, accounting, and haircut considerations discussed in the previous section) to total assets;
- pledgable assets (e.g., unpledged securities and loans) as a percent of total assets;
- pledged securities (or pledged assets) to total pledgable securities (or pledgable assets);
- securitizable assets to total assets (sometimes computed to include some assessment of the time frame that may be involved); and
- liquid assets to total assets with the measure of liquid assets being some combination of short-term assets, marketable securities, and securitizable and pledgable assets (ensuring that any pledged assets are not double-counted).

Relative stability or volatility of liabilities as a source of funding. Summary measures used to assess the relative stability or volatility of liabilities as sources of funding often start with assessments of the maturity of liabilities and their ability to be "rolled-over" or renewed under both normal business and potentially adverse circumstances. These measures also represent an attempt to summarize and characterize the use of actual and potential sources of funds, which are estimated in more-detailed cash-flow-projection worksheets. In fact, proper construction of many of these summary measures requires the same analytical assessments required for cash-flow projections. Such measures attempt to gauge and array the relative sensitivity and availability of different sources of funds on the basis of the anticipated behavior of various types of transactions, business activities, funds providers, or other attributes.

Given the difficulties involved in portraying funding sources across the entire continuum of stability and volatility characteristics, along with the complexity of overlaying alternative contingent scenarios on such portrayals, some common summary measures attempt to group funding sources as falling on one side or the other of this continuum. Financial ratios that attempt to portray the extent to which an institution's funding sources are stable include—

- total deposits as a percent of total liabilities or total assets;
- insured deposits as a percent of total deposits;
- deposits with indeterminate maturities as a percent of total deposits; and
- long-term liabilities (defined as maturing beyond a specified time period) to total liabilities.

These measures necessarily employ assumptions about the stability of an institution's deposit base in an attempt to define a set of relatively stable or core funding sources. Liquidity managers and examiners should take care in constructing their estimates of stable or core liabilities for use in such measures. This caution has become especially important as changes in customer sophistication and interest-rate sensitivity have altered behavioral patterns and, therefore, the stability characteristics traditionally assumed for retail and other types of deposits traditionally termed "core." As a result, examiners, liquidity managers, and other parties should use more-granular breakouts of funding sources to assess the relative stability of deposits and should not place undue reliance on standardized traditional measures of core deposits. Breakouts that use such a greater granularity include—

- various breakouts of retail deposits to total deposits based on product type (MMDA, demand deposit, savings account, etc.) and customer segmentation to total deposits or liabilities;
- breakouts of various types of institutional deposits (e.g., collateralized deposits of municipal and government entities) as a percent of deposits; and
- various breakouts of brokered deposits (by size, types of fund providers, and maturity).

At the other end of the stability/volatility continuum, some summary measures focus on identifying those sources of funding that need to be rolled over in the short term under normal business conditions and those whose rollover or usage in the future may be especially sensitive to institution-specific contingent liquidity events. These measures include—

- short-term liabilities (defined as fund sources maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of total liabilities;
- short-term brokered deposits as a percent of total deposits;
- insured short-term brokered deposits as a percent of total deposits;
- purchased funds (including short-term liabilities such as fed funds purchased, repos, FHLB borrowings, and other funds raised in secondary markets) as a percent of total liabilities;
- uncollateralized purchased funds as a percent of total liabilities; and
- short-term purchased funds to total purchased funds.

When computing measures to assess the availability of potential sources of funds under contingent liquidity scenarios, institutions may adjust the carrying values of their liabilities in order to develop best estimates of available funding sources. Similar to the haircuts applied when assessing marketable securities and liquid assets, such adjustments endeavor to identify more-realistic rollover rates on current and potential funding sources.

Balance between funding needs and sources. Measures used to assess the relationship between actual or potential funding needs and funding sources are constructed across a continuum that arrays both the tenor or relative liquidity of assets and the potential volatility or stability of liabilities. Many of these measures use concepts discussed earlier regarding the liquidity of assets and the relative stability or volatility of liabilities as funding sources. Some measures express various definitions of short-term liquid assets to total liabilities or alternative definitions of volatile or stable liabilities to total assets. Such measures may include—

- net short-term liabilities (short-term liabilities minus short-term assets) as a percent of total assets;
- stable deposits as a percent of total assets;
- total purchased funds as a percent of total assets;
- uncollateralized borrowings as a percent of total assets; and
- liquid assets as a percent of total liabilities.

Other measures attempt to identify the relationships between different classifications of liquid or illiquid assets and stable or volatile liabilities. Exhibit 6 provides a conceptual schematic of the range of relationships that are often addressed in such assessments.

Some commonly used summary liquidity measures and ratios focus on the amount of different types of liquid assets that are funded by various types of short-term and potentially volatile liabilities (upper-left quadrant of exhibit 6). One of the most common measures of this type is the "net short-term position" (used by some NRSROs). Liquidity managers, bank supervisors, and rating agencies use this measure to assess an institution's ability to meet its potential cash obligations over a specified period of time. It is computed as an institution's liquid assets (incorporating appropriate haircuts on marketable assets) minus the potential cash obligations expected over the specified time period (e.g., 3 months, 6 months, or 1 year). Other measures used to assess the relationship or coverage of potentially volatile liabilities by liquid assets include—

- short-term investments (defined as investments maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of short-term and potentially volatile liabilities; and
- short-term investments (defined as investments maturing within a specified time period, such as 3 months, 6 months, or 1 year) as a percent of short-term liabilities (defined as liabilities maturing within a specified time period, such as 3 months, 6 months, or 1 year).

Other summary liquidity measures take a more expansive approach to assessing the continuum of liquid assets and volatile liabilities by including more items or expanding the breadth of analysis. Such measures include—

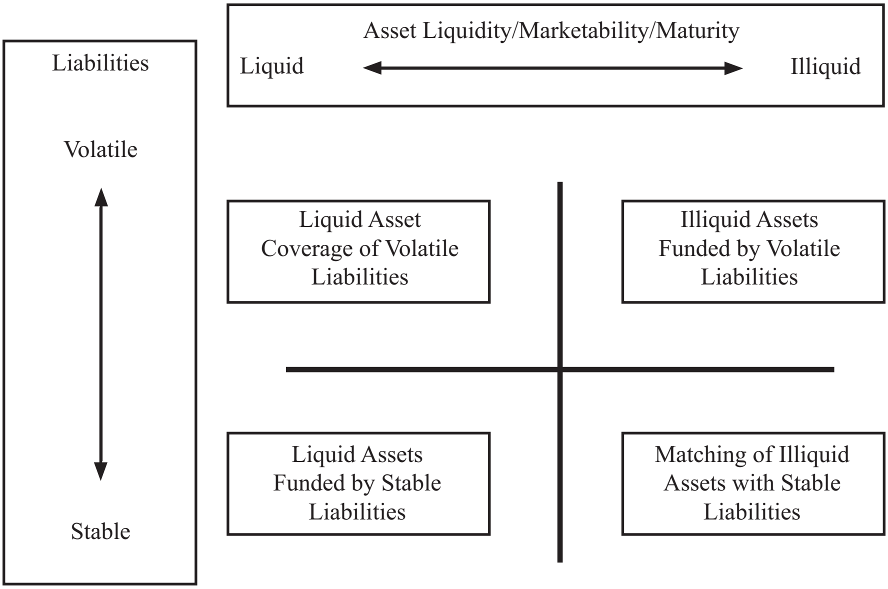
- liquid assets (defined as a combination of short-term assets, marketable securities, and securitizable and pledgable assets—ensuring that any pledged assets are not double-counted—over a certain specified time frame) as a percent of liabilities judged to be volatile (over the same time period);
- liquidity-surplus measures, such as liquid assets minus short-dated or volatile liabilities; and
- liquid assets as a percent of purchased funds.

Other common summary measures of liquidity focus on the potential mismatch of using short-term or potentially volatile liabilities to fund illiquid assets (upper-right-hand quadrant of exhibit 6). Often these measures factor only those volatile liabilities in excess of short-term and highly liquid assets or marketable investment securities into this assessment. Such volatile-liability-dependence measures provide insights as to the extent to which alternative funding sources might be needed to fund long-term liquidity needs under adverse liquidity conditions. These measures include—

- net short-term noncore-funding-dependence measures, such as short-term volatile funding minus short-term investments as a percent of illiquid assets; and
- net volatile-funding-dependence measures, such as volatile funding minus liquid assets as a percent of illiquid assets.

Another set of summary liquidity ratios can be constructed to focus on the extent to which illiquid assets are match-funded by stable liabilities (lower-right quadrant of exhibit 6). Common examples of such measures include traditional loan-to-deposit ratios (which incorrectly assume all deposits are stable) and loan-to-core-

Exhibit 6—Relationships Between Liquid or Illiquid Assets and Stable or Volatile Liabilities



deposit ratios (which often take a product-specific approach to defining the stability of certain types of deposits). However, since such traditional measures necessarily require the use of broad assumptions on the stability of deposits, they should not be relied on to provide meaningful insights regarding potential funding mismatches between stable funding sources and illiquid assets.

One meaningful measure used to gauge such relationships is the concept of "net cash capital" (which is also used by some NRSROs). This measure is the dollar amount by which stable sources of funds exceed illiquid assets; it can be computed as a percent of total assets to facilitate comparisons across institutions. In addition, it can be computed using customized assessments of the relative stability of different types of liabilities and the ability to convert assets into cash through sale, securitization, or collateralization. For example, firms may choose to exclude portions of loans sold regularly (e.g., loans conforming to secondary-market standards) as illiquid assets, or they may choose to include long-term debt as stable liabilities.

A final set of summary measures are used by liquidity managers to optimize the liquidity profiles of their institutions. These measures assess the extent to which relatively stable funding sources are used to fund short-term and liquid assets (lower-left quadrant of exhibit 6). Since short-term liquid assets generally entail relatively lower returns than longer-term less-liquid assets, measures assessing such potential mismatches focus liquidity managers on the cost of carrying liquid assets.

V. Liquidity-Measurement Considerations for Bank Holding Companies

Liquidity-risk measurement considerations for BHCs can be found in the *Bank Holding Company Supervision Manual*, sections 4000.1, 4010, and 4020.

APPENDIX 2—SUMMARY OF MAJOR LEGAL AND REGULATORY CONSIDERATIONS

The following discussions summarize some of the major legal and regulatory considerations that should be taken into account in managing the liquidity risk of banking organizations. The discussions are presented only to highlight potential issues and to direct bankers and supervisors to source documents on those issues.

A. Federal Reserve Regulation A

Federal Reserve Regulation A addresses borrowing from the discount window. Rules defining eligible collateral can be found in this regulation.

B. Federal Reserve Regulation D

Federal Reserve Regulation D addresses required reserves for deposits. One portion of the regulation, however, restricts the type of eligible collateral that can be pledged for repurchase-agreement borrowings.

C. Federal Reserve Regulation F

Federal Reserve Regulation F imposes limits on interbank liabilities. This regulation implements section 308 of the Federal Deposit Insurance Corporation Improvement Act (FDICIA). Banks that sell funds to other banks must have written policies to limit excessive exposure, must review the financial condition or credit rating of the debtor, must have internal limits on the size of exposures that are consistent with the credit risk, may not lend more than 25 percent of their capital to a single borrowing bank, and must undertake other steps.

Banks that borrow federal funds or other borrowings from correspondent banks may find, as a result of the seller's compliance with Regulation F, that the amount they may borrow has suddenly declined as a result of a reduction in their credit rating or credit quality. Regulation F may make it harder for a bank to use borrowings as a liquidity source for a bank-specific liquidity crisis.

D. Federal Reserve Regulation W

Federal Reserve Regulation W governs transactions between an insured bank or thrift and its affiliates. The regulation establishes a consistent and comprehensive compilation of requirements found in section 23A of the Federal Reserve Act, 70 years of Board interpretations of section 23A, section 23B of the Federal Reserve Act, and portions of the Gramm-Leach-Bliley Act of 1999. Covered transactions include purchases of assets from an affiliate, extensions of credit to an affiliate, investments in securities issued by an affiliate, guarantees on behalf of an affiliate, and certain other transactions that expose the member bank to an affiliate's credit or investment risk. Derivatives transactions and intraday extensions of credit are also covered.

The intentions of the regulation are (1) to protect the depository institution, (2) to ensure that all transactions between the bank and its affiliates are on terms and conditions that are consistent with safe and sound banking practices, and (3) to limit the ability of a depository institution to transfer to its affiliates the subsidy arising from the institution's access to the federal safety net. The regulation achieves these goals in four major ways:

1. It limits a member bank's covered transactions with any single affiliate to no more than 10 percent of the bank's capital stock and surplus, and limits transactions with all affiliates combined to no more than 20 percent of the bank's capital stock and surplus.
2. It requires all transactions between a member bank and its affiliates to be on terms and conditions that are consistent with safe and sound banking practices.
3. It prohibits a member bank from purchasing low-quality assets from its affiliates.
4. It requires that a member bank's extensions of credit to affiliates and guarantees on behalf of affiliates be appropriately secured by a statutorily defined amount of collateral.

Section 23B protects member banks by requiring that certain transactions between the bank and its affiliates occur on market terms, that is, on terms and under circumstances that are substantially the same, or at least as favorable to the bank, as those prevailing at the time for comparable transactions with unaffiliated companies. Section 23B applies the market-terms restriction to any covered transaction (as defined in section 23A) with an affiliate as well as certain other transactions, such as (1) any sale of assets by the member bank to an affiliate, (2) any payment of money or furnishing of services by the member bank to an affiliate, and (3) any transaction by the member bank with a third party if an affiliate has a financial interest in the third party or if an affiliate is a participant in the transaction.

Liquidity-risk managers working in banks that have affiliates must give careful attention to Regulation W, which addresses transactions between banks and their affiliates. In the normal course of business, the prohibition on unsecured funding can tie up collateral, complicate collateral management, and restrict the availability of funding from affiliates. In stressed conditions, all of those problems—plus the size limit and the prohibition on sales of low-quality assets to affiliates—effectively close down many transactions with affiliates.

E. Statutory Restriction of FHLB Advances

The Federal Home Loan Banks (FHLBs) provide a number of different advance programs with very attractive terms to member banks. Many banks now use the FHLBs for term funding. The FHLBs are very credit-sensitive lenders.

A federal regulation (12 CFR 935, Federal Housing Finance Board—Advances) requires the FHLBs to be credit-sensitive. In addition to monitoring the general financial condition of commercial banks and using rating information provided by bank rating agencies, the FHLBs have access to nonpublic regulatory information and supervisory actions taken against banks. The FHLBs often react quickly, sometimes before other funds providers, to reduce exposure to a troubled bank by not rolling over unsecured borrowing lines. Depending on the severity of a troubled bank's condition, even the collateralized funding program may be discontinued or withdrawn at maturity because of concerns about the quality or reliability of the collateral or other credit-related concerns. Contractual provisions requiring increases in collateral may also be invoked. Any of these changes in FHLB-loan availability or terms can create significant liquidity problems, especially in banks that use large amounts of short-term FHLB funding.

F. Statutory Restriction on the Use of Brokered Deposits

The use of brokered deposits is restricted by 12 CFR 337.6. Well-capitalized banks may accept brokered deposits without restriction. Adequately capitalized banks must obtain a waiver from the FDIC to solicit, renew, or roll over brokered deposits. Adequately capitalized banks must also comply with restrictions on the rates that they pay for these deposits. Banks that have capital levels below adequately capitalized are prohibited from using brokered deposits. In addition to these restrictions, banking regulators have also issued detailed guidance, discussed in section H below, on the use of brokered deposits.

G. Legal Restrictions on Dividends

A number of statutory restrictions limit the amount of dividends that a bank may pay to its stockholders. As a result, a bank holding company that depends on cash from its bank subsidiaries can find this source of funds limited or closed. This risk is particularly significant for bank holding companies with nonbank subsidiaries that require funding or debt service.

H. Restrictions on Investments That Affect Liquidity-Risk Management

Interagency guidance issued in 1998 by the FFIEC, "Supervisory Policy Statement on Investment Securities and End-User Activities," contains provisions that may affect liquidity and liquidity management. (See SR-98-12.) The following points summarize some of these potential impacts, although readers should review the entire rule for more-complete information.

1. When banks specify permissible instruments for accomplishing established objectives, they must take into account the liquidity of the market for those investments and the effect that liquidity may have on achieving their objective.
2. Banks are required to consider the effects that market risk can have on the liquidity of different types of instruments under various scenarios.

3. Banks are required to clearly articulate the liquidity characteristics of the instruments they use to accomplish institutional objectives.

In addition, the policy statement specifically highlights the greater liquidity risk inherent in complex and less actively traded instruments.

APPENDIX 3—INTERAGENCY GUIDANCE ON FUNDS TRANSFER PRICING RELATED TO FUNDING AND CONTINGENT LIQUIDITY RISKS

The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued this guidance on funds transfer pricing (FTP) practices related to funding risk (including interest rate and liquidity components) and contingent liquidity risk at large financial institutions (hereafter referred to as "firms") to address weaknesses observed in some firms' FTP practices.[11] The guidance builds on the principles of sound liquidity risk management described in the "Interagency Policy Statement on Funding and Liquidity Risk Management,"[12] and incorporates elements of the international statement issued by the Basel Committee on Banking Supervision titled "Principles for Sound Liquidity Risk Management and Supervision."[13]

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

FTP is an important tool for managing a firm's balance sheet structure and measuring risk-adjusted profitability. By allocating funding and contingent liquidity risks to business lines, products, and activities within a firm, FTP influences the volume and terms of new business and ongoing portfolio composition. This process helps align a firm's funding and contingent liquidity risk profile and risk appetite and complements, but does not replace, broader liquidity and interest rate risk-management programs (for example, stress testing) that a firm uses to capture certain risks (for example, basis risk). If done effectively, FTP promotes more resilient, sustainable business models. FTP is also an important tool for centralizing the management of funding and contingent liquidity risks for all exposures. Through FTP, a firm can transfer these risks to a central management function that can take advantage of natural offsets, centralized hedging activities, and a broader view of the firm.

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

The 2008 financial crisis exposed weak risk-management practices for allocating liquidity costs and benefits across business lines. Several firms "acknowledged that if robust FTP practices had been in place earlier, and if the systems had charged not just for funding but for liquidity risks, they would not have carried the significant levels of illiquid assets and the significant risks that were held off-balance sheet that ultimately led to sizable losses."[14] Refer to SR-16-3.

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

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

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

14. Senior Supervisors Group report on "Risk Management Lessons from the Global Financial Crisis of 2008" (October 21, 2009) is available at www.newyorkfed.org/medialibrary/

Funds Transfer Pricing Principles

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

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

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

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

media/newsevents/news/banking/2009/SSG_report.pdf.

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

FTP costs and benefits should be allocated based on methodologies that are set forth by a firm's FTP framework. The methodologies should be transparent, repeatable, and sufficiently granular such that they align business decisions with the firm's desired funding and contingent liquidity risk appetite. To the extent a firm applies FTP at an aggregated level to similar products and activities, the firm should include the aggregating criteria in the report on FTP.[15] Additionally, the senior management group that oversees FTP should review the basis for the FTP methodologies. The attachment to this interagency guidance describes illustrative FTP methodologies that a firm may consider when implementing its FTP framework.[16]

A firm should allocate FTP costs and benefits, as measured at transaction or trade inception, to the appropriate business line, product, or activity. If a firm retains any FTP costs or benefits in a centrally managed pool pursuant to its FTP framework, it should analyze the implications of such decisions on business line incentives and the firm's overall risk profile. The firm customarily would include its findings in the report on FTP.

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

15. See Principle 3 for a discussion of the report on FTP.
16. The FRB, the FDIC, and the OCC will monitor evolving FTP practices in the market and may update or add to the illustrative methodologies in the interagency guidance attachment.

The firm customarily would include its findings in the report on FTP.

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

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

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

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

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

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

Independent risk and control functions and internal audit should provide oversight of the FTP process and assess the report on FTP, which should be reviewed as appropriate to reflect changing business and financial market conditions and to maintain the appropriate alignment of incentives. Lastly, consistent with existing supervisory guidance on model risk management,[17] models used in FTP implementation should be independently validated and regularly reviewed to ensure that the models continue to perform as expected, that all assumptions remain appropriate, and that limitations are understood and appropriately mitigated.

17. Refer to FRB's SR-11-7, "Guidance on Model Risk Management" and OCC Bulletin 2011-12, "Supervisory Guidance on Model Risk Management."

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

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

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

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

Conclusion

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

Interagency Guidance Attachment Illustrative Funds Transfer Pricing Methodologies

March 1, 2016

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

Non-Trading Exposures

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

Matched-Maturity Marginal Cost of Funding

Matched-maturity marginal cost of funding is a commonly used methodology for non-trading exposures. Under this methodology, FTP costs and benefits are based on a firm's market cost of funds across the term structure (for example, wholesale long-term debt curve adjusted based on the composition of the firm's alternate sources of funding such as Federal Home Loan Bank advances and customer deposits). This methodology incentivizes business lines to generate stable funding (for example, core deposits) by crediting them the benefit or premium associated with such funding. It also ensures that business lines are appropriately charged the cost of funding for the life of longer-dated assets (for example, a five-year commercial loan). Given that funding costs can change over time, the market cost of funds across the term structure should be derived from reliable and readily available data sources and be well understood by FTP users.

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

Contingent Liquidity Risk

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

Trading Exposures

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

Weighted Average Cost of Debt (WACD)

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

Marginal Cost of Funding

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

Contingent Liquidity Risk

A firm may calculate the FTP costs related to contingent liquidity risk from trading exposures by considering the unencumbered liquid assets that are held to cover the potential for widening haircuts of trading exposures that are funded secured. If haircuts used in a firm's FTP framework do not align with haircuts used in its internal stress test for similar types of trading exposures, the firm should document and include in the report on FTP these inconsistencies. Haircuts should be updated at a frequency that is appropriate for a firm's trading activities and market conditions.

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

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Liquidity

DISCOUNT WINDOW OVERVIEW

Federal Reserve lending to depository institutions (referred to as the "discount window") plays an important role in supporting the liquidity and stability of the U.S. banking system and the effective implementation of monetary policy.[1] By providing ready access to funding, the discount window helps depository institutions manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress. Thus, the discount window supports the smooth flow of credit to households and businesses. Providing liquidity in this way is one of the original purposes of the Federal Reserve System and other central banks around the world.

The Board's Regulation A (12 CFR pt. 201) governs the discount window. Under Regulation A, three credit programs are available to depository institutions:

1. Primary credit,
2. Secondary credit, and
3. Seasonal credit

Each credit program has its own interest rate ("discount rate"). Rates are established by each Reserve Bank's board of directors, subject to the review and determination of the Board of Governors of the Federal Reserve System. The rates for each of the three lending programs are the same across all Reserve Banks.

Depository institutions must have collateral available to pledge and meet certain eligibility criteria for primary credit at the discount window. The following assets are most commonly pledged to secure discount window advances:

- commercial, industrial, or agricultural loans
- consumer loans
- residential and commercial real estate loans
- corporate bonds and money market instruments
- obligations of U.S. government agencies and government-sponsored enterprises
- asset-backed securities
- collateralized mortgage obligations
- U.S. Treasury obligations
- state or political subdivision obligations

A Reserve Bank is not obligated to extend credit to any depository institution but may lend to a depository institution by making an advance secured by acceptable collateral as described in the Federal Reserve Act. 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.

To access the discount window, depository institutions must deliver the necessary lending agreements and corporate resolutions under the terms set forth in the Federal Reserve's lending agreement. Operating Circular No. 10, "Lending," issued by each Reserve Bank, establishes the credit and security terms for borrowings from the Federal Reserve.[2]

DISCLOSURES

The Dodd-Frank Wall Street Reform and Consumer Protection Act,[3] which amended the Federal Reserve Act, requires the Federal Reserve to disclose certain discount window lending information. Effective for discount window loans (primary, secondary, and seasonal credit) extended on or after July 21, 2010, the Federal Reserve publicly discloses the following information, generally about two years after a discount window loan is extended to a depository institution:

- the name and identifying details of the depository institution;
- the amount borrowed by the depository institution;
- the interest rate paid by the depository institution; and
- information identifying the types and amounts of collateral pledged in connection with any discount window loan. This disclosure requirement does not apply to collateral pledged by depository institutions that do not borrow.

1. For more information, see the Board's website and the discount window website.

2. For more information on the Federal Reserve's Operating Circulars, see FRBservices.org.

3. Pub. L. No. 111-203.

The purpose of these disclosures is to promote public transparency, accountability, and legitimacy in the discount window process.

PRIMARY CREDIT, SECONDARY CREDIT, AND SEASONAL CREDIT

Primary Credit

The Federal Reserve's primary credit program offers depository institutions an additional source of available funds (at a rate above the target federal funds rate) for managing short-term liquidity risks.[4] Advances under primary credit may be made for a term of up to 90 days. Historically, advances under primary credit have been for very short terms, usually overnight. Primary credit is the principal safety valve for ensuring adequate liquidity in the banking system. There are no restrictions on borrowers' use of primary credit.

Depository institutions that are in "generally sound financial condition in the judgment of the Reserve Bank" are eligible for primary credit.[5] Sound financial condition typically means the depository institution has a CAMELS composite rating of "1," "2," or "3" and is adequately or well capitalized per prompt corrective action statutes (see table 1).

Table 1. General eligibility criteria for primary or secondary credit

Examination Rating (CAMELS or equivalent)	*Capital Designation*	*Generally Eligible For*
1, 2, or 3	Adequately or well capitalized	Primary Credit
4 or 5	Any	Secondary Credit
Any	Less than Adequately Capitalized	Secondary Credit

4. See the Board's Regulation A (12 CFR pt. 201) for additional information on the Federal Reserve's credit programs that are available to qualifying institutions.
5. 12 CFR 201.4(a).

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, if, in the judgment of the Reserve Bank, the loan is consistent with the institution's timely return to a reliance on market sources of funds. If necessary for the orderly resolution of serious financial difficulties of an institution, a Reserve Bank may extend longer-term secondary credit. Any discount window loan, including a longer-term secondary credit loan, would have to comply with requirements for lending to undercapitalized and critically undercapitalized institutions. For more information, see the subsection below titled, "Lending to Undercapitalized and Critically Undercapitalized Depository Institutions." Secondary credit may not be used to fund an expansion of the institution's assets. Compared with the primary credit program, the secondary credit program entails a higher level of Reserve Bank administration and oversight. Reserve Banks will collect information to confirm the borrowing is consistent with the objectives of the program. Secondary credit is available at a rate above the primary credit rate.

Seasonal Credit

Under the seasonal lending program, a depository institution may qualify for funding for up to nine months during the calendar year, to meet seasonal borrowing needs of the communities it serves. The seasonal lending program is for institutions with demonstrated liquidity pressures of a seasonal nature and will not normally be available to institutions with deposits of $500 million or more. Institutions that experience fluctuations in deposits and loans—caused by construction, college, farming, resort, municipal financing, and other seasonal types of business—frequently qualify for the seasonal lending program. The interest rate charged on seasonal credit loans is a floating market rate comprised of the average of the federal funds rate and the rate on three-month certificate of deposits rounded to the nearest five basis points. The rate for seasonal credit can be lower than the rate applied to primary credit. Furthermore, the interest rate is reset every two weeks and applies to all outstanding seasonal credit loans.

LENDING TO UNDER-CAPITALIZED AND CRITICALLY UNDERCAPITALIZED DEPOSITORY INSTITUTIONS

Credit from any Reserve Bank to an "undercapitalized" institution may be extended or outstanding for no more than 60 days during any 120-day period in which the institution is undercapitalized.[6] 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.

CONTINGENCY FUNDING AND THE FEDERAL RESERVE DISCOUNT WINDOW

As described in this manual's section on Liquidity Risk, a contingency funding plan provides a plan for responding to a liquidity crisis; identifies a menu of contingent liquidity sources that the institution can use under adverse liquidity circumstances; and describe steps that should be taken to ensure that the institution's sources of liquidity are sufficient to fund scheduled operating requirements and meet the institution's commitments with minimal costs and disruption. The Federal Reserve and other federal banking agencies encourage depository institutions to incorporate the discount window as part of their contingency funding plans. The following attributes make the primary credit program a viable source of backup or contingency funding at institutions for the short-term:

- Primary credit provides an accessible source of backup, short-term funding.
- Primary credit can enhance diversification in short-term funding sources that are part of contingency funding plans.
- Borrowings can be secured with an array of collateral, including consumer and commercial loans, in addition to many classes of fixed income securities and commercial paper.
- Requests for primary credit advances can be made anytime during the business day.[7]
- There are no restrictions on the borrowers' use of primary credit.

If the discount window is a part of a depository institution's contingency funding plan, the depository institution should establish and maintain operational readiness to borrow from the discount window.[8] Operational readiness includes establishing borrowing arrangements with the Reserve Bank and ensuring collateral is available for borrowing in an amount appropriate for a depository institution's potential contingency funding needs. If an institution incorporates primary credit into its contingency funding plan, management should

- ensure that they are familiar with the pledging process for different collateral types and be aware that pre-pledging collateral can be useful if liquidity needs arise quickly;
- consider regularly testing the institution's ability to borrow at the discount window. The goal of such testing is to ensure that there are no unexpected impediments or complications in the case that such contingency lines need to be used.
  - — Depository institutions should consider conducting small value transactions at regular intervals to ensure familiarity with discount window operations. Examination staff will not criticize institutions for testing discount window access;
- have viable short-term liquidity contingency sources that can replace primary credit at the discount window, if necessary; and

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

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

8. For more information, see the Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans (July 28, 2023).

- determine the institution's eligibility for primary credit under various stress scenarios, recognizing that if its financial condition were to deteriorate, primary credit may not be available. Under those scenarios, secondary credit may need to be accessed.

INTRODUCTION

Borrowed funds are a common and practical method for banks to manage their liquidity needs and to fund their operations. A bank's borrowings may exist in a number of forms. Sources of bank borrowings can include Federal Home Loan Bank (FHLB) credit lines, federal funds purchased, loans from correspondent banks, repurchase agreements, and the Federal Reserve discount window. Other borrowings include intraday credit from a Federal Reserve Bank, interest-bearing demand notes issued to the U.S. Treasury (the Treasury tax and loan note option account), mortgages payables, due-bills, and other types of borrowed securities. Borrowings can also include rediscounted customer paper and assets sold with the bank's endorsement or guarantee. For the purposes of this section, borrowings exclude long-term subordinated debt, such as capital notes and debentures.

Reasons a bank may borrow funds include the following:

- To meet the temporary or seasonal loan demand or deposit withdrawal needs of its customers.
- To meet large and unanticipated deposit withdrawals by its customers that may arise during periods of economic distress.
- To manage liabilities effectively.

For banks using borrowed funds as one of their sources for ongoing or contingent funding, bank management should

- address specific liquidity risks associated with borrowed funds in the bank's contingency funding planning;
- be aware of the operational steps required to obtain funding from contingency funding sources, including potential counterparties, contact details, and availability of collateral;[1]
- as applicable, fully understand the credit policies and standards of the entities lending to the bank; and
- estimate the amount of funding that would be available from funds providers under both normal and stress conditions, including if there are changes in the bank's financial condition.

Some of the more frequently used sources of borrowings are discussed below.

COMMON SOURCES OF BORROWINGS

FHLB Borrowings

The FHLB system was created by the Federal Home Loan Bank Act as a government-sponsored enterprise to support mortgage lending and related community investment. There are 11 regional FHLBs. The FHLB system 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, the FHLBs were permitted to lend to banks as well.

The FHLBs are a common funding source for many community and regional banks. The FHLBs provide banks short-term and long-term borrowings, with maturities ranging from overnight to 30 years, at generally competitive interest rates. The flexibility of an FHLB facility enables bank management to use this source of funds for the purpose of asset/liability management and contingency funding planning. FHLB facilities may allow bank 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.

Bank management should understand the contracts associated with borrowing from an FHLB, including which assets collateralize the borrowings and the potential risks presented by the contract. For example, the FHLB borrowing agreement may require a bank to pledge all of its assets to the FHLB that have not already been pledged for other purposes (e.g., pledged as collateral to the Reserve Bank to secure discount window borrowings). Furthermore, a bank with negative tangible common equity could lose access to FHLB funding. Regulations governing the FHLBs' extensions of credit provide that an

1. See the July 2023, "Addendum to the Interagency Policy Statement on Funding and Liquidity Risk Management: Importance of Contingency Funding Plans."

FHLB shall not make new advances to a member that does not have positive tangible capital unless that member's appropriate federal banking agency or insurer requests in writing that the FHLB make such advance.[2]

Federal Funds Transactions

Federal funds transactions involve a bank's lending (federal funds sold) or borrowing (federal funds purchased) of immediately available funds under agreements or contracts that have an original maturity of one business day or roll over under a continuing contract. Federal funds may take the form of the following two types of transactions:

1. Unsecured loans (federal funds sold) or borrowings (federal funds purchased). In some market usage, the term "fed funds" or "pure fed funds" is confined to unsecured loans of immediately available balances.
2. Purchases (sales) of financial assets (other than securities) under agreements to resell (repurchase) that have original maturities of one business day (or are under continuing contracts) and are in immediately available funds.

Funds lent or borrowed in the form of securities resale or repurchase agreements, due-bills, borrowings from the discount window, deposits with and advances from a FHLB, and overnight loans for commercial and industrial purposes are excluded from federal funds.

For federal funds transactions, the rate is usually determined by overall money market rates as well as by the available supply and demand for funds. In some instances, when the selling and buying relationship between two banks is continuous, an effective line of credit may be established on a funds-availability basis. While federal funds transactions commonly are unsecured, the selling of funds can also be secured and can be for a longer period of time. Agency-based federal funds transactions are discussed in section 5230.1, "Bank Dealer Activities."

2. 12 CFR 1266.4.

Loans from Correspondent Banks

Small and medium-sized banks often negotiate loans from their principal correspondent banks to meet their funding needs. The loans are usually for a short period of time and may be secured or unsecured. For more information, see section 6006.1, "Regulation F: Correspondent Concentration Risks."

Repurchase Agreements and Associated Risks

A repurchase agreement or repo is a transaction involving the sale of financial assets by one party to another, subject to an agreement by the seller to repurchase the assets at a specified date or under specific circumstances. A reverse repurchase agreement or reverse repo is a transaction involving the purchase of financial assets by one party from another, subject to an agreement by the purchaser to resell the assets at a specified date or under specific circumstances. Such transactions are referred to as a repo when viewed from the perspective of the supplier of the securities, and a reverse repo or matched sale-purchase agreement when described from the point of view of the supplier of funds. For more information on repurchase agreements, see the instructions to the Call Report.

Both parties in a term repo arrangement are exposed to interest rate risk. To mitigate this risk, a common practice is 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. 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.

Repurchase agreements are in many respects economically 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 funding plans should outline alternative funding sources.

Borrowings from the Federal Reserve

Federal Reserve lending to depository institutions (referred to as the "discount window") plays an important role in supporting the liquidity and stability of the banking system and the effective implementation of monetary policy. By providing ready access to funding, the discount window helps depository institutions manage their liquidity risks efficiently and avoid actions that have negative consequences for their customers, such as withdrawing credit during times of market stress. Thus, the discount window supports the smooth flow of credit to households and businesses.

Three types of credit are available from the Federal Reserve Banks: primary credit, secondary credit, and seasonal credit, each with its own interest rate. For more information about the discount widow, see section 3210.1, "The Discount Window and Liquidity Risk Management."

The Federal Reserve also has an important role in providing intraday balances and credit to foster the smooth functioning of the overall payment system. Federal Reserve Banks provide intraday credit (also known as daylight overdrafts) to eligible depository institutions with accounts at a Federal Reserve Bank. A daylight overdraft occurs when an institution's Federal Reserve Bank account is in a negative position at any point during the business day. For more information, see the Federal Reserve Policy on Payment Systems Risk.

SUPERVISORY CONSIDERATIONS WHEN ANALYZING BORROWINGS

Examiners should analyze the purpose, effectiveness, and stability of each bank's borrowings on their own merits. The review of bank borrowings generally contributes to the supervisory assessment of the institution's "Liquidity" rating. The "Liquidity" rating should be based on, among other things, the degree of the bank's reliance on short-term, volatile sources of funds, including borrowings and brokered deposits, that have been used to fund the bank's longer-term assets.

If a bank borrows extensively or in large amounts, examiners should appropriately analyze the bank's borrowing activity by

- reviewing the principal sources of its borrowings, range of amounts, frequency, length of time indebted, borrowing costs, and reasons for the borrowings;
- verifying the actual use of the borrowed funds;
- analyzing changes in a bank's borrowing position for signs of deterioration in its borrowing ability and overall creditworthiness. Possible signs of deterioration in borrowing ability include;
  - — The payment of large fees to money brokers to obtain funds because the bank is having difficulty obtaining access to conventional sources of borrowings. For more information about the risks associated with brokered deposits, see section 2330.1, "Deposit Accounts";
  - — Requests from the bank's lender for collateral on previously unsecured credit lines or increases in collateral margins;
  - — The payment of above-market interest rates; and
  - — A shortening of maturities that is inconsistent with management's articulated balance-sheet strategies and funding plans.

If a bank's borrowing position is not properly managed, examiners should include appropriate comments in the report of examination.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Liquidity

INTRODUCTION

Market risk reflects the degree to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can adversely affect a financial institution's earnings or capital. For most community banks, market risk primarily reflects exposure to interest rate risk (IRR). While this risk is a normal part of banking and can be an important source of profitability and shareholder value, excessive levels of IRR can pose a significant threat to an institution's earnings and capital base. Accordingly, effective risk management that maintains IRR at prudent levels is essential to the safety and soundness of institutions.

The Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR 208, appendix D-1) require an institution to manage IRR in a manner that is appropriate to the size of the institution and the complexity of its assets and liabilities; and provide for periodic reporting to management and the board of directors regarding interest rate risk with adequate information for management and the board of directors to assess the level of risk. As a result, an important element of examinations and the supervisory process is the evaluation of an institution's exposure to changes in interest rates. Examiners evaluate both the adequacy of the management process used to control IRR and the quantitative level of exposure. In addition, examiners should assess the existing and potential future effects of changes in interest rates on an institution's financial condition, including the effect on the institution's capital adequacy, earnings, liquidity, and asset quality.

This section incorporates and builds upon the principles and guidance provided in four Supervision & Regulation (SR) letters:

- SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations";
- SR-96-13, "Joint Policy Statement on Interest Rate Risk";[1]
- SR-10-1, "Interagency Advisory on Interest Rate Risk"; and
- SR-12-2, "Questions and Answers on Interagency Advisory on Interest Rate Risk Management."

1. See also 61 Fed. Reg. 33,166 (June 26, 1996).

TYPES AND SOURCES OF MARKET RISK

Market risk can arise from a variety of sources, including

- the overall structure of an institution's balance sheet, especially its loans, investments, and funding structure;
- its use of off-balance-sheet instruments (such as derivatives) for speculation; and
- its trading activities, if any.

While IRR is the most common form of market risk, market risk also arises from exposure to foreign exchange rates, commodity prices, and equity prices.

Foreign exchange risk surfaces when an institution, typically a larger or internationally active institution, performs foreign currency transactions on behalf of its customers, through either wire transfer activity or forward currency contracts. Institutions also may be exposed to currency fluctuations if they have a significant amount of investments denominated in foreign currencies. Institutions can be adversely affected when currencies in which they hold assets weaken or when currencies in which they have obligations strengthen. Foreign exchange risk also arises indirectly when changes in exchange rates affect the competitive position of an institution that operates in different countries.

Commodity price risk is similar to equity risk and encompasses the changes in an institution's earnings and asset values resulting from fluctuations in commodity prices. Some institutions are active in the commodity derivative market, offering derivative contracts linked to commodity prices. In addition, an institution's borrowers can be affected significantly by changes in commodity prices, such as the effect of fluctuating oil prices on airlines or in the realm of agricultural lending.

Equity price risk is the variation in profit or net worth caused by the changes in the prices of individual shares or the level of stock markets as a whole. Equity risk has both direct and indirect results. Fluctuations in stock prices will directly affect the value of shares, portfolios, and equity derivatives held by an institution. There also may be an indirect effect when declining equity prices affect the viability of a company to which the bank has loaned money. Banks generally do not hold equity investments.

TYPES OF INTEREST RATE RISK

As previously discussed, IRR is the most common form of market risk for banking institutions. IRR can arise from a variety of sources, including repricing risk, yield curve risk, basis risk, options risk, and price risk. Various assets and liabilities may be exposed to more than one type of IRR.

Repricing risk is the primary and most discussed source of IRR and is the risk that the institution's assets, liabilities, and off-balance-sheet (OBS) instruments will reprice at different times or amounts. Repricing mismatches are fundamental to the business of banking and generally occur from either short term liabilities funding longer-term assets or long term liabilities funding shorter-term assets. Institutions whose liabilities reprice faster than their assets reprice are considered to be liability sensitive. The earnings of a liability sensitive institution generally increase when interest rates fall and decrease when rates rise. Conversely, an asset sensitive institution's assets reprice more quickly than their liabilities. These institutions' earnings generally benefit from a rising rate environment and are harmed by a falling rate environment.

Yield curve risk is the relationship between changing rates for the same instrument across a spectrum of maturities. It arises when assets and funding sources are linked to similar indexes with different maturities and the shape or slope of the yield curve changes by flattening, steepening, or inverting. For example, a 30-year Treasury bond's yield may change by 200 basis points; however, the three-year Treasury note's yield only changed by 50 basis points during the same time period.

Basis risk arises from a change in the relationship or spread between different market indexes. It occurs when the market indexes used to price assets and liabilities change by different amounts or at different times. For example, assume an operator uses a Treasury bill (T-bill) to hedge an interest rate risk in Eurodollars. The interest rates for T-bills and Eurodollars do not always move exactly parallel to each other. The risk of this lack of parallel movement is basis risk. The second occurs when the period of time for which a financial risk exists is not identical with the period of time for which the hedge is arranged, for example, when a three-month interest risk in a revolving Eurodollar loan is hedged with a six-month futures contract in Eurodollars. A change in the shape of the yield curve can bring about nonparallel movements in interest rates for the two different maturities.

Options risk is the risk arising from the options in assets, liabilities, and OBS instruments. An option provides the holder with the right, but not the obligation, to buy, sell, or, in some manner, alter the cash flow of an instrument or financial contract. Options may be distinct instruments, such as exchange-traded and over-the-counter contracts, or they may be embedded within the contractual terms of other instruments. Instruments with embedded options include bonds and notes with call or put provisions (e.g., callable U.S. agency notes), loans that give borrowers the right to prepay balances without penalty (e.g., residential mortgage loans), and various types of non-maturity deposit instruments that give depositors the right to withdraw funds at any time without penalty (e.g., demand deposits).

Price risk is the risk that the fair value of financial instruments will change when interest rates change. For example, trading portfolios, held-for-sale loan portfolios, and mortgage servicing assets contain price risk.

EFFECTS OF INTEREST RATE RISK

IRR can expose an institution's earnings and capital to adverse changes in market interest rates.

In assessing the effects of changing rates on earnings, institutions' measurement systems may focus on either net interest income or net income. In general, institutions focus primarily on net interest income—the difference between total interest income and total interest expense. However, interest rates can affect other income components, especially fee-based income. In particular, non-interest income generated by loan servicing and various asset-securitization programs can be highly sensitive to changes in market interest rates. Institutions with significant non-interest income that is sensitive to changing rates should have measurement systems in place that focus on net income.

Market interest rates also affect the value of an institution's assets, liabilities, and OBS instruments and, thus, effect the value of an institution's equity capital. The economic value of an instrument is an assessment of the present value of its expected net future cash flows, discounted to reflect market rates.[2] Interest rate changes can have a material effect on the economic value of an instrument. For example, the economic value of a bond with a fixed coupon rate generally falls in a rising rate environment. By evaluating changes in the institution's economic value for a given change in interest rates, institution management can identify risk arising from long-term repricing or maturity gaps as the interest rate environment may affect the institution's future earnings or capital values.

Historically, banks have managed their IRR exposures adequately and few have failed solely as a result of adverse interest rate movements. Changes in interest rates can have negative effects on profitability and need to be carefully managed, especially given the rapid pace of financial innovation and the heightened level of competition among all types of financial institutions.

ORGANIZATIONAL PROCESSES AND CONTROLS FOR MANAGEMENT OF INTEREST RATE RISK

Risk-Management Framework

As is the case in managing other types of risk, sound IRR management involves effective oversight and a comprehensive risk-management process that includes the following elements:

- effective policies and procedures designed to control the nature and amount of IRR, including clearly defined IRR limits and lines of responsibility and authority;
- appropriate risk-measurement, monitoring, and reporting systems; and
- effective internal controls that include an independent review and/or audit of key elements of the risk-management process.

The formality and sophistication used in managing IRR often varies by size and sophistication of the institution, the nature and complexity of its holdings and activities, and the overall level of its IRR. Less complex practices may be adequate for well-managed institutions with noncomplex activities and holdings that present a low IRR profile.

More complex institutions and those with higher IRR exposures or holdings of complicated instruments likely require sophisticated and formal IRR management systems to address their broader range of financial activities. In addition, formal IRR management systems generally will provide an institution's senior management with the needed information to monitor and direct day-to-day activities. The more complex IRR management processes often employed at these institutions may warrant a more thorough independent review and validation process of the IRR model utilized.

Individuals involved in the risk-management process should be sufficiently independent of business lines to ensure adequate separation of duties and avoid potential conflicts of interest. The degree of autonomy these individuals have may be a function of the size and complexity of the institution. In smaller institutions with limited resources, it may not be possible to completely remove individuals with business-line responsibilities from the risk-management process. In these situations, and assuming the institution engages in less complex activities, the institution's focus should be directed towards ensuring that risk-management functions are conducted appropriately. Larger, more complex institutions should have separate and independent risk-management units.

Board of Directors and Senior Management Oversight

The board of directors and senior management have unique yet complementary responsibilities related to the oversight and management of the institution's IRR risk profile.

2. For some instruments, the economic value of an instrument may be the same or differ from its fair value depending on the facts and circumstances. The fair value is an accounting term and is generally considered to be the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. For more information on fair value and the fair value measurement of derivatives, see ASC Topic 820, "Fair Value Measurement" as well as the Call Report instructions.

Board of Directors

The board of directors is ultimately responsible for establishing the institution's level of IRR. The board of directors or a board committee should oversee the establishment, approval, and periodic review of IRR management strategies, policies, procedures, and limits (or risk tolerances). In addition, the board or a board committee should understand the implications of the IRR strategies that the institution pursues, including their potential impact on market, liquidity, credit, and operational risks. To be appropriately informed about the institution's IRR exposure, the nature of risks in current and proposed new activities, and the adequacy of the institution's risk-management process, the board or its committee should receive reports from senior management that contain sufficient detail to assist in making informed policy decisions. The frequency of board reports depends on the complexity of the institution's holdings and the materiality of changes in its holdings.

Unlike senior management, the members of an institution's board of directors do not necessarily need to have detailed technical knowledge of complex financial instruments, legal issues, or sophisticated risk-management techniques. However, the institution's board of directors should oversee and hold senior management accountable for appropriately measuring, monitoring, and controlling IRR.

Senior Management

Senior management should be responsible for implementing

- adequate systems and standards for measuring risk,
- standards for valuing positions and measuring performance,
- a comprehensive IRR reporting and monitoring process, and
- effective internal controls and review processes.

Senior management should be responsible for implementing board-approved strategies, policies, and procedures as well as managing IRR within the designated lines of authority and responsibility. Senior management should develop and implement policies and procedures that align with the board's goals, objectives, and risk limits. Senior management should be responsible for overseeing institution personnel to confirm that operating standards are being followed. Further, senior management should assure that institution personnel who perform analysis and risk-management activities related to IRR have the technical knowledge, depth, and experience commensurate with the nature and scope of the institution's activities.

Reports to senior management should provide aggregate information as well as sufficient supporting detail, so that management can assess the sensitivity of the institution to changes in market conditions and other important risk factors. Effective IRR reports generally include measurement of IRR exposures relative to limits and disclosure of key assumptions. Senior management should also periodically review the institution's IRR management policies and procedures to assess the appropriateness of its risk management. Senior management should also discuss risk-measurement, reporting, and management procedures with risk-management staff. These discussions will assist senior management in developing and providing IRR reports to the board of directors that contain sufficient detail to assist in making informed policy decisions for the institution.

Policies, Procedures, and Limits

Institutions should have clear policies and procedures for limiting and controlling IRR. In general, these policies and procedures should

- delineate lines of responsibility and accountability over IRR management decisions,
- clearly define authorized instruments and permissible hedging and position-taking strategies,
- identify the frequency and method for measuring and monitoring IRR, and
- specify quantitative limits that define the acceptable level of risk for the institution.

In addition, management should define the specific procedures and approvals necessary for exceptions to policies, limits, and authorizations. All IRR risk policies should be reviewed by management and approved by the board of directors at least annually and revised as needed.

Clear Lines of Authority

Whether through formal written policies or operating procedures, management should define the structure of managerial responsibilities, oversight, and lines of authority in the following areas:

- developing and implementing strategies and tactics used in managing IRR
- establishing and maintaining an IRR measurement and monitoring system that is commensurate with the institution's size and complexity
- identifying potential IRR and related issues arising from the use of new products
- developing IRR management policies, procedures and limits, and authorizing exceptions to policies and limits

Individuals and management committees responsible for making decisions about IRR management should be clearly identified. Most institutions delegate IRR management responsibilities to a committee of senior managers, sometimes called an asset/liability committee (ALCO). At these institutions, policies identify the ALCO membership, the committee's duties and responsibilities, the extent of its decisionmaking authority, and the form and frequency of its reports to senior management and the board of directors. An ALCO should have sufficiently broad participation across major banking functions (for example, lending, investment, deposits, and funding) so that its decisions can be executed effectively throughout the institution. In many large institutions, the ALCO delegates day-to-day responsibilities for IRR management to an independent risk-management department or function.

Individuals involved in the IRR management process (including separate risk-management units, if present) should be sufficiently independent from the business lines, including through the reporting structure, to provide for adequate separation of duties and avoid potential conflicts of interest. Also, personnel charged with measuring and monitoring IRR should have a well-founded understanding of the institution's IRR profile. Compensation policies for these individuals should be adequate enough to attract and retain personnel who are well qualified to assess the risks of the institution's activities, and are compatible with effective controls and risk management.

Authorized Activities

Institutions should clearly identify the types of financial instruments that are permissible for managing IRR, either specifically or by their characteristics. As appropriate to its size and complexity, the institution should delineate procedures for acquiring specific instruments, managing individual portfolios, and controlling the institution's aggregate IRR exposure. Major hedging or risk-management initiatives should be approved by the board or board committee before being implemented.

Before introducing new products, hedging, or position-taking initiatives, management should also determine whether there are adequate operational procedures and risk-control systems in place and whether procedures need to be revised.

Risk Limits

The goal of IRR management is to maintain an institution's IRR exposure within self-imposed parameters over a range of possible changes in interest rates. A system of IRR limits and risk-taking guidelines assists an institution in achieving that goal. Such a system should set limits for the institution's level of IRR and, where appropriate, provide the capability to allocate these limits to individual portfolios or activities. Systems should also identify for management when a limit is violated to allow for prompt management attention. Further, in the event of a limit violation, an institution's processes should address specific escalation procedures outlining designated responsible personnel and risk mitigation procedures.

Risk limits should be appropriate to the size, complexity, and financial condition of the institution. Depending on the nature of an institution's holdings and general sophistication, limits can be identified for individual business units, portfolios, instrument types, or specific instruments.[3] The level of detail of risk limits should reflect the characteristics of the institution's holdings, including the various sources of IRR to which the institution is exposed. Limits applied to portfolio categories and individual instruments should be consistent with and

3. This manual's section on "Investment Securities and End-User Activities" discusses issues in setting price volatility limits in the acquisition of securities and derivatives.

complementary to consolidated limits. For example, an institution should consider whether

- IRR limits are consistent with the institution's overall approach to measuring and managing IRR and address the potential impact of changes in market interest rates on both reported earnings and the institution's economic value of equity (EVE);
- limits are consistent with the risk tolerance of the board of directors;
- IRR tolerances address the potential impact of changing interest rates on capital and earnings from a short-term and a long-term perspective;
- limits on the IRR exposure of earnings, which primarily address short term exposure, are broadly consistent with those used to control the exposure of an institution's economic value, which reflects long term exposure;
- IRR limits and risk tolerances consider specific scenarios of market interest rate movements, such as an increase or decrease of a particular magnitude; and
- the rate movements used in developing these limits represent meaningful stress situations, taking into account historic rate volatility and the time required for management to address exposures.

Interest Rate Risk Monitoring and Reporting

An effective process of measuring, monitoring, and reporting exposures is essential for adequately managing IRR. The sophistication and complexity of this process should be appropriate to the size, complexity, nature, and mix of an institution's business lines and its IRR characteristics.

Effective IRR measurement systems monitor the effect of rate changes on both earnings and economic value. The latter is particularly important for institutions with significant holdings of intermediate and long-term instruments or instruments with embedded options because their market values can be particularly sensitive to changes in market interest rates.

IRR measurement systems should

- assess material IRR associated with an institution's assets, liabilities, and OBS positions;
- use generally accepted financial concepts and risk-measurement techniques; and
- have well-supported assumptions and parameters.

In many cases, the interest rate characteristics of an institution's largest holdings will dominate its aggregate risk profile. While all of an institution's holdings should receive appropriate treatment, measurement systems should provide more detailed information on the major holdings and instruments whose values are especially sensitive to rate changes. The IRR measurement system should have sufficient functionality and sophistication to properly identify and value instruments with significant embedded or explicit option characteristics.

An accurate, informative, and timely management information system is essential for managing IRR exposure, and ensuring risks and activities align with the institution's policies and risk tolerance. Reporting of risk measures should be regular and clearly compare current exposure with the institution's internal risk limits. In general, senior management should receive quarterly reports on the institution's IRR profile. The reports should utilize current and accurate data. More frequent reporting may be appropriate depending on the institution's exposure to IRR and the potential for significant changes to the institution's capital and earnings. In addition, past forecasts or risk estimates should be compared with actual results as one tool to identify any potential shortcomings in modeling techniques.[4]

The types of reports prepared for the board and for various levels of management will vary based on the institution's IRR profile. Effective IRR reports enable senior management to

- evaluate the level of and trends in the institution's aggregate IRR exposure;
- demonstrate and verify compliance with the institution's policies and limits;
- evaluate the sensitivity and reasonableness of key assumptions;
- assess the results and future implications of major hedging or position-taking initiatives that have been taken or are being actively considered;

4. For more information, see SR-11-7, "Guidance on Model Risk Management."

- understand the implications of various stress scenarios, including those involving breakdowns of key assumptions and parameters;
- review IRR policies, procedures, and the adequacy of the IRR measurement systems; and
- determine whether the institution holds sufficient capital for the level of risk being taken.

IRR Measurement Methods

There are a number of techniques to measure the IRR exposure of both earnings and economic value. Their complexity ranges from simple calculations and static simulations using current holdings to highly sophisticated dynamic modeling techniques that reflect potential future business and business decisions. Regardless of the methods used, an institution's IRR measurement system should be sufficiently robust to capture material on and off-balance-sheet positions and incorporate a stress-testing process to identify and quantify the institution's IRR exposure and potential problem areas.

The most common types of IRR measurement systems are

- Gap Analysis
- Earnings Simulation Analysis
- Economic Value of Equity (EVE)

Each risk-measurement system has limitations and vary in the degree of its ability to capture various components of IRR. The following exhibit demonstrates the types of interest rate exposures that each measurement system generally addresses. While different methodologies capture different risk exposures, outputs from all models should generally provide a consistent view of IRR trends. If divergent outcomes occur, they are typically due to the structure of the balance sheet, the interest rate environment, the timing of asset/liability mismatches, the sensitivity of funding sources to interest rate changes, or the volume of fixed or floating rate assets. Institution management should understand the nature and underlying reasons for material differences in outputs.

Gap analysis is a basic IRR measurement technique utilizing a maturity/repricing schedule, which distributes assets, liabilities, and OBS holdings into time bands according to their final maturity (if fixed rate) or time remaining to their next repricing (if floating). The choice of time bands may vary from institution to institution. Those assets and liabilities lacking contractual repricing intervals or maturities are assigned to repricing time bands according to the judgment and analysis of the institution.

Table 1—Interest Rate Exposures by Measurement Systems

	Gap Analysis	Earnings Simulation Analysis	Economic Value of Equity
Short-term earnings exposure	Yes	Yes	Limited*
Long-term exposure	Yes	Limited*	Yes
Repricing risk	Yes	Yes	Yes
Yield curve risk	Limited*	Yes	Yes
Basis risk	Limited*	Yes	Limited*
Option risk	Limited*	Limited*	Yes
Price risk	Limited*	Limited*	Yes

*Depending on the sophistication of the model and the manner in which it is used

Gap analysis can be used to generate rough indicators of the IRR sensitivity of both earnings and economic values to changing interest rates. To evaluate earnings exposures, liabilities arrayed in each time band can be subtracted from the assets arrayed in the same time band to yield a dollar amount of maturity/repricing mismatch or gap in each time band. The direction and magnitude of the gaps in various time bands can demonstrate potential earnings volatility arising from changes in market interest rates. A maturity/repricing schedule also can evaluate the effects of changing rates on an institution's economic value.

Typically, gap analysis includes ratios of rate-sensitive assets to rate-sensitive liabilities in given time periods. Within a given time band, an institution may have a positive, negative, or neutral gap. An institution with a positive gap is "asset sensitive" for the given time band because more assets than liabilities are subject to repricing. An institution with a negative gap is "liability sensitive" for the given time band because more liabilities than assets are subject to repricing. An institution with a neutral gap (a ratio of rate-sensitive assets to rate-sensitive liabilities equal to one) is neither asset nor liability sensitive for the given time band.

At the most basic level, mismatches or gaps in long-dated time bands can provide insights into the potential vulnerability of the economic value of relatively noncomplex institutions. However, gap analysis alone is generally not suitable for adequately assessing the institution's risk profile for the large majority of institutions. Long-term gap calculations, along with simple maturity distributions of holdings, may be sufficient for relatively noncomplex institutions with basic balance sheets, minimal optionality, and mainly repricing risk.

Earnings simulation analysis estimates cash flows and resulting earnings streams over a specific time period under various interest rate scenarios to estimate the effect of interest rate changes on net interest income or net income. For assessing the exposure of earnings, simulations estimating cash flows and resulting earnings streams over a specific period are conducted based on existing holdings and assumed interest rate scenarios. A simulation model's accuracy depends on the use of accurate assumptions and data.

A key aspect of IRR simulation involves the selection of an appropriate time horizon(s) over which to assess IRR exposures. Simulations can be performed over any time horizon and often are used to analyze multiple horizons identifying short-term, intermediate-term, and long-term risk. Utilizing a two-year time period generally is effective when using earnings simulation models. A two-year time frame effectively captures an institution's important transactions, tactics, and strategies to increase revenues, which can be hidden by viewing projected results within shorter time horizons. However, to assess the effects of certain products with embedded options, IRR simulations over longer time horizons (five-to-seven years) are typically needed.

Income simulations are static or dynamic. Static simulations are based on current holdings and assume a constant balance sheet with no new growth. Dynamic simulations include assumptions of asset growth, changes in existing business lines, new business, or changes in management or customer behaviors. Dynamic earnings simulation models can be useful for business planning and budgeting purposes. However, dynamic simulations are highly dependent on key variables and assumptions and can be inaccurate over an extended period. Furthermore, model assumptions, such as growth, can potentially hide underlying risk exposures. Therefore, static and dynamic simulations, in tandem, should be used to provide a more complete description of the institution's IRR exposure.

Economic value of equity (EVE) models consider the present value of expected cash flow over the entire expected life of the institution's holdings. EVE models simulate various interest rate scenarios to estimate the changes in an institution's economic value of capital as a result of changes in interest rates. This approach focuses on a longer-term time horizon, captures future cash flows expected from existing assets and liabilities, and is effective in considering embedded options in a typical institution's portfolio.

Most EVE models use a static approach by providing a snapshot in time of the risk inherent in the portfolio or balance sheet. However, some institutions incorporate dynamic modeling techniques that provide forward-looking estimates of economic value.

When utilizing EVE methods, institution management should establish appropriate EVE risk limits. Appropriate limits generally are based on the change of economic capital rather than absolute levels of economic capital. The accuracy of the assumptions in the model are critically important in the EVE model's ability to calculate the future cash flows of the institution's instruments. Unreasonable assumptions can lead to pronounced output errors in EVE models. As such, institution management should understand the significance and accuracy of assumptions by conducting sensitivity testing.

IRR Scenarios

IRR exposure estimates, whether linked to earnings or economic value, use some form of forecasts or scenarios of possible changes in market interest rates. Institution management should measure IRR exposure estimates over a probable range of potential interest rate scenarios, including meaningful stress situations. The scenarios should adequately cover the institution's meaningful sources of IRR associated with its holdings. In developing appropriate scenarios, institution management should consider the current level and term structure of rates and possible changes to that environment, given the historical and expected future volatility of market rates.

There are various common rate scenarios, including rate shock, rate ramp, stair step, and non-parallel yield curve shifts. A rate-shock scenario is the most commonly used. In this scenario, rate changes are instantaneous and sustained. For instance, a plus 300 basis-point, rate-shock scenario would consist of the full 300 basis-point interest rate increase occurring in the first period measured and remain in effect for all measured periods. A rate ramp scenario consists of rate changes applied gradually over a measured period, such as a 300 basis-point rate increase during a 12-month period with rates rising 25 basis points each month. A stair-step scenario also consists of rate changes applied gradually; however, the changes are administered at less frequent intervals. For example, a 300 basis-point increase might be measured over a two-year period with rates increasing 50 basis points per quarter the first year and 25 basis points per quarter the second year. Nonparallel yield curve shifts are scenarios in which the yields do not change by the same number of basis points for every maturity, such as flattening, steepening, or inversion of the yield curve.

Effective scenarios conducted by institution management typically include an instantaneous plus or minus 200 basis-point parallel shift in market rates (rate shock). However, those scenarios alone may not adequately assess an institution's IRR exposure. As such, institutions should also consider utilizing changes in rates of greater magnitude, such as plus or minus 300 and 400 basis-point shocks. More sophisticated analyses involve the use of multiple scenarios, including the potential effects of changes in the relationships among interest rates (option risk and basis risk) and changes in the general level of interest rates and changes in the shape of the yield curve.

Data Integrity

In addition to validity of the underlying assumptions, and IRR scenarios used to model IRR exposures, the usefulness of IRR measurements depends on the integrity of the data on current holdings. Simulation techniques that rely heavily on specific assumptions should be used carefully because they rely on specific assumptions and parameters, which can lead to inaccurate reports if the underlying data is inaccurate.

The integrity of data on current positions is an important component of the risk-measurement process. Management should ensure that all material positions are represented in IRR measures, and that the data used are accurate and meaningful. IRR measurement techniques should reflect relevant repricing and maturity characteristics on key holdings. When applicable, data should include information on the contractual coupon rates and cash flows of associated instruments and contracts. Manual adjustments to underlying data should be supported and controlled.

Account Aggregation

Account aggregation is the process of grouping and measuring accounts of similar types and cash flow characteristics. The account aggregation process should be supported and periodically reviewed. The level of account aggregation from transaction systems into the IRR model will vary from one institution to another based the complexity of the accounts and the sophistication of the IRR model. Institutions should appropriately aggregate current account positions by meaningful characteristics (for example, by instrument type, coupon rate, or repricing characteristic). This allows the institution to appropriately measure material types and sources of IRR, including those arising from explicit or embedded options. Both contractual and behavioral characteristics should be considered when determining the cash flow patterns of accounts to aggregate.

Assumptions

Assumptions should be documented and their effects should be well understood by management. Management should review the assumptions used in assessing the interest rate sensitivity of complex instruments, such as those with embedded options, and instruments with uncertain maturities. Management should assess the consistent replacement growth rate assumptions if the ban uses dynamic simulations of future growth and business assumptions. Assumptions about customer behavior and new business should consider historical patterns and be consistent with the interest rate scenarios used. Institutions should review the reasonableness of assumptions covering asset prepayments, non-maturity deposit price sensitivity and decay rates, and key rate drivers for each interest rate shock scenario.[5]

The following discussion provides background information on the types of assumptions used in IRR models.

Driver rates and betas. Driver rates are utilized in most earnings simulations and economic value models and represent the rate or rates which drive the re-pricing characteristics of assets and liabilities. Examples of driver rates include the fed funds rate, U.S. Treasury yields, and the Wall Street Journal Prime rate. Depending on the sophistication of the model, a variety of driver rates may be tailored to the different products the institution offers. While institution rates generally move in relation to a driver rate, the movement may be less or more than the movement in the driver rate depending on management's pricing strategies. Most models utilize a beta factor to serve as a proxy for management's reaction to market changes. A beta factor represents the magnitude of the changes in the rates of bank products compared to the changes in the driver rates. For example, management may be expected to only increase deposit rates by 40 basis points for every 100 basis points move in the fed funds rate, resulting in a beta factor of 40 percent. Beta factors should be based on an analysis of the relationship between the product and the driver rate. To help determine the beta, management can perform correlation or regression analysis to quantify the historical relationship between the product and the drivers.

Non-maturity deposits. Assumptions about non-maturity deposits are critical as non-maturity deposits represent a large portion of the industry's funding base. An institution's IRR measurement system should consider the sensitivity of non-maturity deposits, including demand deposits, negotiable order of withdrawal accounts, savings deposits, and money market deposit accounts. There are a variety of techniques used to analyze IRR characteristics, and each institution should use a technique that is commensurate to the size, sophistication, and complexity of the institution. In general, treatment of non-maturity deposits should consider the historical behavior of the institution's deposits; general conditions in the institution's markets, including the degree of competition it faces or likely to face; and anticipated pricing behavior under the scenario investigated.

As non-maturity deposits have no contractual maturity date, institutions should utilize assumptions that determine the maturity of the accounts. The most common assumption utilized is a decay rate. Also, institutions experiencing or projecting capital levels that trigger brokered and high interest rate deposit restrictions should adjust deposit assumptions accordingly.[6]

Assumptions, including deposit betas and decay rates, should be supported to the fullest extent practicable. Treatment of non-maturity deposits within the measurement system may, of course, change from time-to-time based on market and economic conditions. Such changes should be well founded and documented. Treatments used in constructing earnings simulation assessments should be conceptually and empirically consistent with those used in developing EVE assessments of IRR.

Asset prepayment. Prepayment assumptions reflect the optionality and prepayment risk associated with loans and mortgage-related securities and are critical as cash flows may be received more quickly or more slowly than anticipated. Prepayments are highly influenced by the direction of interest rates as loan prepayments generally slow during periods of rising rates. Prepayment assumptions should take into consideration various factors, such as aging, geographic location, loan size, and fixed versus variable rates.

Stress Testing

Stress testing, which includes both scenario and sensitivity analysis, is an important part of IRR management. An institution's risk-measurement system for IRR should contain a meaningful evaluation of the effect of stressful market conditions on the institution. Stress scenarios should be designed to provide informa-

5. A decay rate estimates the amount of existing non-maturity deposit that will run off over a given time period. Generally, rate-sensitive and higher-cost deposits, such as brokered and Internet deposits, should reflect higher decay rates than other types of deposits.

6. Section 38 of the FDI Act (12 U.S.C. 1831o) requires insured depository institutions that are undercapitalized to receive approval before engaging in certain activities, and further restricts interest rates paid on deposits by institutions that are not well capitalized. Section 38 restricts or prohibits certain activities and requires an insured depository institution to submit a capital restoration plan when it becomes undercapitalized.

tion on the kinds of conditions under which the institution's strategies or positions would be most vulnerable; thus, testing may be tailored to the risk characteristics of the institution. Possible stress scenarios might include more severe changes in the term structure of interest rates, substantial rate changes over time, relationships among key market rates (basis risk), or volatility of market rates. The stress testing of assumptions used for illiquid instruments and instruments with uncertain contractual maturities, such as core deposits, is particularly critical to achieving an understanding of the institution's risk profile. Therefore, stress scenarios may include extremes of observed market conditions and plausible worst-case scenarios.

Management should conduct sensitivity analysis of the assumptions having the largest influence on an institution's model output under stressful situations. This sensitivity analysis may consist of testing key assumptions or variables by changing the variable in question while keeping all other variables constant and comparing the results to the base-case scenario. Based on the results of sensitivity analysis, management should be able to identify the assumptions which have the most impact on model output. This enables management to focus their efforts in verifying the most salient assumptions. Additionally, sensitivity analysis can be used to determine the conditions under which key business assumptions and model parameters or when IRR may be exacerbated by other risks or earnings pressures.

Internal Controls

An important element of an institution's internal controls for IRR is senior management's comprehensive evaluation and review of the various components of the IRR management process. Although procedures for establishing limits and adhering to them may vary among institutions, periodic control reviews should be conducted to determine whether the organization enforces its IRR policies and procedures. Senior management should promptly address situations where interest rate positions exceed established internal risk limits. Issues should be resolved based on processes described in approved policies. The institution should conduct periodic reviews of IRR management process. Reviews should also be conducted in light of significant changes since the last review, such as the nature of instruments acquired, as well as modifications to risk-measurement methodologies, limits, and internal controls.

Validating IRR models is a fundamental part of any institution's system of internal controls. An important element of model validation is independent review of the model's logical and conceptual soundness. The scope of the independent review should assess the institution's measurement of IRR, including the reasonableness of assumptions, the process used in determining assumptions, and the back testing of assumptions and results. Management also should implement adequate follow-up procedures to monitor the institution's corrective actions. The results of these reviews should be available for the relevant supervisory authorities.

Smaller institutions that do not have the resources to staff an independent review function should have processes in place to ensure the integrity of the various elements of their IRR management processes. Often, smaller institutions will use an internal party that is sufficiently removed from the primary IRR functions or an external auditor to independently verify the integrity of the IRR models used. More robust model validations processes for measurement systems are appropriate for institutions with complex risk exposures. These processes should include review by external auditors or other knowledgeable outside parties to ensure the IRR models' adequacy and integrity. Since measurement systems may incorporate one or more subsidiary systems or processes, institutions should ensure that multiple component systems are well integrated and consistent in all critical respects.

The frequency and extent to which an institution should reevaluate its risk-measurement methodologies and models depends, in part, on the specific IRR exposures created by their holdings and activities, the pace and nature of changes in market interest rates, and the extent to which there are new developments in measuring and managing IRR. In general, an institution should review its underlying IRR measurement methodologies and IRR management process annually, and more frequently as institution behaviors and market conditions dictate.

SUPERVISORY CONSIDERATIONS IN ASSESSING IRR SENSITIVITY TO MARKET RISK

Quantitative Level of IRR Exposure and Effect on Earnings and Capital

Examiners evaluating the quantitative level of IRR should review and assess the effects of past and potential changes in interest rates on an institution's financial condition, particularly its earnings, capital, liquidity, and, in some cases, asset quality. This assessment involves a broad analysis of an institution's business mix, balance-sheet composition, OBS holdings, and holdings of interest rate-sensitive instruments. Examiners should understand the institution's material holdings, and assess how changes in interest rates might affect the institution's financial performance. While the scope of the assessment should reflect the size, sophistication, and nature of the institution's holdings, primary areas of review include

- major on- and off-balance-sheet positions,
- concentrations in interest-sensitive instruments,
- the existence of highly volatile instruments, and
- significant sources of noninterest income that may be sensitive to changes in interest rates.

IRR Exposure to Earnings and Capital

An institution's IRR exposure should be assessed in terms of the potential effects on the institution's earnings and capital. When evaluating the potential effects of changing rates on an institution's earnings, examiners will assess the key determinants of the net interest margin, the effect that fluctuations in net interest margins can have on overall net income, and the rate sensitivity of non-interest income and expense. Analyzing the historical behavior of the net interest margin, including the yields on major assets, liabilities, and off-balance-sheet positions that make up that margin, can provide useful insights into the relative stability of an institution's earnings. Examiners should evaluate the exposure of earnings to changes in interest rates relative to the institution's overall level of earnings and the potential length of time such exposure might persist.

Exposures that would result in a significant decline in net interest margins or net income should prompt further investigation of the adequacy and stability of earnings and the adequacy of the institution's risk-management process. Specifically, in institutions exhibiting significant earnings exposures, examiners should emphasize the results of the institution's stress tests to determine the extent to which more significant and stressful rate moves might magnify the erosion in earnings identified in the more modest rate scenario.

When determining the amount of IRR exposure in context of capital, examiners will consider the effect of changes in market interest rates on the economic value of equity, level of embedded losses in the bank's financial structure, and impact of potential rate changes on the institution's earnings.

Examiners should take into account the absolute level of an institution's earnings or capital both before and after the estimated IRR shock. Institutions with strong earnings and capital can withstand greater shocks, whereas institutions with already less than satisfactory earnings or capital may warrant greater supervisory concern at relatively small IRR shocks.

Qualitative Assessment of Interest Rate Risk Management

When evaluating interest rate risk management at an institution, examiners should place primary consideration on the following elements of a sound risk-management system:

- board of directors and senior management oversight;
- policies, procedures, and limits;
- risk monitoring and management information systems; and
- internal controls.[7]

Through discussions with appropriate institution personnel, examiners should determine whether the institution has established appropriate corporate governance processes (internal

7. These elements are consistent with the guidance provided in SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $50 Billion."

policies, procedures, risk limits, and strategies), and whether the board of directors, or a committee thereof, is regularly informed about the level and trend of IRR, and reviews conformance with internal IRR policy limits and risk tolerances. If inadequacies are noted, examiners should communicate these findings to the institution and discuss strategies to improve the institution's corporate governance processes.

Examiners should determine whether internal measurement processes and systems are adequate. In particular, examiners should review the institution's input process by focusing on the procedures for entering and reconciling system data, categorizing and aggregating account data, ensuring the completeness of account data, and assessing the effectiveness of internal controls. In addition, examiners should review the results of the audit or independent reviews, and determine whether the results were appropriately reported to the board of directors, or a committee thereof, and whether the results revealed significant deficiencies.

EXAMINATION PROCESS

Examiners should assess and assign a rating to the sensitivity to market risk component, or "S" component, of the CAMELS rating system, at each full-scope examination.[8] To meet examination objectives efficiently and effectively while remaining sensitive to potential burdens imposed on institutions, the examination of sensitivity to market risk should follow a structured, risk-focused approach. A fundamental tenet of this approach is that supervisory resources are targeted at functions, activities, and holdings that pose the most risk to the safety and soundness of an institution. Accordingly, institutions with low levels of IRR would be expected to receive relatively less supervisory attention than those with more severe IRR exposures.

Many institutions have become especially skilled in managing and limiting the exposure of their earnings to changes in interest rates. Accordingly, for most banks and especially for smaller institutions with less complex holdings, the IRR element of the examination may be relatively simple and straightforward. On the other hand, some banks consider IRR an intended consequence of their business strategies and choose to take and manage that risk explicitly—often with complex financial instruments. These banks, along with banks that have a wide array of activities or complex holdings, generally should receive greater supervisory attention.

Examination Scope and Off-Site Analysis

During the examination scoping process prior to the on-site examination, examiners should use surveillance metrics and supervisory judgment, to determine bank's risk tier (low, moderate, or high). The scope of the examination work program should align with the bank's risk classification. More information on the use of surveillance metrics during the examination scoping process is discussed in this manual's section entitled, "Community Bank Supervision Process."

Additionally, examiners should assess the level of IRR exposure and the quality of IRR management to the fullest extent possible during the scoping process by reviewing the following:

- organizational charts and policies identifying authorities and responsibilities for managing IRR;
- IRR policies, procedures, and limits;
- ALCO committee minutes and reports (from 6 to 12 months before the scope visit);
- board of director reports on IRR exposures;
- audit reports (both internal and external);
- most recent IRR report, including assumptions used in the model; and
- Federal Reserve surveillance reports and supervisory screens.

If the examiners' assessment of the risk tier differs from the initial quantitative risk tier, examiners should adjust the risk tier. Adjustments to the risk tier during the scoping process based on examiner judgement should be rationalized and documented in the appropriate work papers.

During the Examination

Examiners should complete the appropriate examination procedures based on the bank's assigned risk tier. During the examination, the

8. There may be instances where the assessment of sensitivity to market risk is a topic of a targeted examination.

examiner-in-charger and the examiner working the IRR portion of the examination should confirm the risk classifications on which planned work programs were based and, if needed, adjust or expand the work programs. If initial discussions with management or additional information obtained during the examination indicates significant weakness in the bank's risk management or higher-than-anticipated risk, examiners should modify the examination's scope and work programs accordingly. All examination work programs are to include the review and verification of corrective action taken to address any outstanding Matters Requiring Immediate Attention (MRIAs) or Matters Requiring Attention (MRAs).

Material weakness in risk management or high levels of IRR exposure relative to earnings and capital may require corrective action. If an examiner determines that an IRR weakness warrants corrective action based on safety and soundness, the examiner, in consultation with the examiner-in-charge, should outline any MRIAs or MRAs.

When issuing a supervisory finding (including through the issuance of an MRIA or MRA), examiners will not criticize an institution for a "violation" of supervisory guidance (as supervisory guidance is not legally binding). When appropriate, examiners may reference (including in writing) supervisory guidance (such as interagency statements, advisories, bulletins, and policy statements) to provide examples of safe-and-sound conduct, appropriate risk-management practices, and other approaches to addressing compliance with laws or regulations.[9]

Assessing CAMELS Ratings

For most banks, IRR is the primary market risk exposure. Accordingly, the CAMELS market-risk sensitivity or "S" rating for most banks should be based on assessments of the adequacy of IRR management practices and the quantitative level of IRR exposure.[10] In particular, the "S" rating for most banks where IRR is the primary market risk exposure should be based on an assessment of the following evaluation factors:

- the sensitivity of the bank's earnings or the economic value of its capital to adverse changes in interest rates;
- the ability of management to identify, measure, monitor, and control exposure to interest rate risk given the bank's size, complexity, and risk profile;
- the nature and complexity of interest rate risk exposure arising from non-trading positions; and
- where appropriate, the nature and complexity of market-risk exposure arising from trading and foreign operations.

In addition to these listed factors, there may be additional factors that may be appropriate for the examiner to evaluate as part of determining the "S" rating for a bank.

The "S" component rating definitions of the CAMELS rating system are as follows:

1. A rating of "1" indicates that interest rate risk sensitivity is well controlled and that there is minimal potential that the earnings performance or capital position will be adversely affected. Risk-management practices are strong for the size, sophistication, and market risk accepted by the institution. The level of earnings and capital provide substantial support for the degree of interest rate risk taken by the institution.
2. A rating of "2" indicates that interest rate risk sensitivity is adequately controlled and that there is only moderate potential that the earnings performance or capital position will be adversely affected. Risk-management practices are satisfactory for the size, sophistication, and interest rate risk accepted by the institution. The level of earnings and capital provide adequate support for the degree of interest rate risk taken by the institution.
3. A rating of "3" indicates that control of interest rate risk sensitivity needs improvement or that there is significant potential that the earnings performance or capital position will be adversely affected. Risk-management practices need to be improved given the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital may not adequately support the degree of interest rate risk taken by the institution.

9. SR-18-5/CA-18-7, "Interagency Statement Clarifying the Role of Supervisory Guidance."

10. "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System," provides guidance on the market-risk sensitivity component of the CAMELS rating system.

4. A rating of "4" indicates that control of interest rate risk sensitivity is unacceptable or that there is high potential that the earnings performance or capital position will be adversely affected. Risk-management practices are deficient for the size, sophistication, and level of risk accepted by the institution. The level of earnings and capital provide inadequate support for the degree of interest rate risk taken by the institution.

5. A rating of "5" indicates that control of interest rate risk sensitivity is unacceptable or that the level of risk taken by the institution is an imminent threat to its viability. Risk-management practices are wholly inadequate for the size, sophistication, and level of interest rate risk accepted by the institution.

The adequacy of a bank's IRR management is a leading indicator of its potential IRR exposure. Therefore, assessment of IRR management practices should be the basis for the overall assessment of a bank's IRR. Unsafe exposures and management weaknesses should be fully reflected in "S" ratings. Unsafe exposures and unsound management practices that are not resolved during the on-site examination should be addressed through subsequent follow-up actions by the examiner and other supervisory personnel.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Rate Sensitivity

4000—MANAGEMENT ACTIVITIES AND INTERNAL CONTROLS

The 4000 series of sections explain key concepts related to bank management and internal controls. These sections address the supervisory approach for the assessment of a bank's risk management practices over certain banking activities. There are also sections on key aspects of an effective internal controls framework.

Directors are placed in a position of trust by the bank's shareholders, and both statutes and common law place responsibility for the affairs of a bank firmly and squarely on the board of directors. The board of directors of a bank should delegate the day-to-day routine of conducting the bank's business to its officers and employees, but the board cannot delegate its responsibility for the consequences of unsound or imprudent policies and practices, whether they involve lending, investing, protecting against internal fraud, or any other banking activity. The board of directors is responsible to the bank's depositors, other creditors, and shareholders for safeguarding their interests through the lawful, informed, efficient, and able administration of the institution. In the exercise of their duties, directors are governed by federal and state banking, securities, and antitrust statutes, as well as by common law, which imposes a liability on directors of all corporations. Directors who fail to discharge their duties completely or who are negligent in protecting the interests of depositors or shareholders may be subject to removal from office, criminal prosecution, civil money penalties imposed by bank regulators, and civil liability. See section 5040 of this manual, "Formal Corrective Actions," which describes those enforcement powers in greater detail.

DIRECTOR SELECTION

The affairs of each state member bank are overseen by its board of directors. The initial directors are elected by the shareholders at a meeting held before the bank is authorized to commence business. Thereafter, they are elected at meetings held at least annually on a day specified in the bank's bylaws. The directors hold office for a stated tenure, generally ranging from one to three years, or until their successors are elected and have qualified. No state member bank is to have less than five or more than 25 directors as specified in section 31 of the Banking Act of 1933. Various laws govern the election, number, qualifications, oath, liability, and removal of directors and officers, as well as the disclosure requirements for their outside business interests. Other laws pertain to certain restrictions, prohibitions, and penalties for securities dealers serving as directors, officers, or employees; director interlocks; purchases of assets from, or sales to, directors; commissions and gifts for procuring loans; embezzlement; abstraction; willful misapplication; false entries; political contributions; and other matters. The examiner must be familiar with these laws and the related regulations and interpretations.

DIRECTOR INDEPENDENCE

Directors must exercise their independent judgment when managing the bank's affairs. A responsible board will not merely rubber-stamp management's recommendations, but will review them carefully before deciding whether they are in the bank's best interests. A board that is excessively influenced by management, a single director, or a shareholder, or any combination thereof, may not be fulfilling its responsibilities to depositors, other creditors, and shareholders. Diversification of the board of directors is important and can be accomplished by including directors with no ownership or family-ownership interest in the bank and who are not employed by the bank.

A bank's board of directors may include one or more advisory directors. Advisory directors generally do not vote but may provide additional information or advice to the voting directors. An advisory director who functions in that capacity is generally not subject to the same regulatory requirements as voting members and has less liability for the board's actions. However, if an advisory director exercises a degree of influence or control over the board or the bank that is not commensurate with that status, it is appropriate for examiners to subject that individual to the same standards as voting directors. Such a person might also be subject to the same liability standards as a voting director.

DIRECTORS' RESPONSIBILITIES

Directors play a critical role in overseeing the affairs of the bank. Directors should understand that if they neglect to carry out their fiduciary duties and responsibilities, they may be financially liable if the bank fails or experiences loss. An examiner sometimes has to remind bank directors of the extent of their duties and responsibilities. Unless bank directors realize the importance of their positions and act accordingly, they are failing to discharge their obligations to the shareholders, depositors, other creditors, and the community.

Selection of Competent Executive Officers

One of the board's most important duties is to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. The board is also responsible for removing officers who do not meet reasonable standards of honesty, competency, executive ability, and efficiency. The responsibility for selecting executive officers also entails retaining them and ensuring that competent successors can be promoted or hired to fill unanticipated voids. The board is responsible for evaluating the performance of the chief executive officer and approving the CEO's compensation. In many banks, the board also approves compensation for other executive officers.

A state member bank that has been chartered or undergone a change of control within the last two years, that is not in compliance with the minimum capital adequacy guidelines or regulations of the Board, or that is in an otherwise troubled condition must provide 30 days' written notice to its regulating Reserve Bank before it can add a director, promote an internal staff member to senior executive officer, or employ a new senior executive officer.

Effective Supervision of Bank Affairs

The type and degree of supervision required of a bank's board of directors to ensure a bank is soundly managed involve reasonable business judgment and competence and sufficient time to become informed about the bank's affairs. Directors ultimately are responsible for the soundness of the bank. If negligence is involved, a director may be personally liable. The responsibility of directors to supervise the bank's affairs may not be delegated to the active executive officers or anyone else. Directors may delegate to executive officers certain authority, but not the primary responsibility of ensuring that the bank is operated in a sound and legal manner.

Adoption and Adherence to Sound Policies and Objectives

The directors' role is to provide a clear framework of objectives and policies within which the chief executive officer can operate and administer the bank's affairs. This framework is often accomplished through the use of strategic plans and budgets. The strategic plan would discuss long-term, and in some cases, short-term goals and objectives as well as how progress toward their achievement will be measured. The objectives and policies should cover all areas of the bank's operations. The board of directors is responsible for establishing the policies that govern and guide the day-to-day operations of the bank, so they should review and approve them from time to time. These policies are primarily intended to ensure that the risks undertaken by the banks are prudent and are being properly managed. This means that the board of directors must, as a group, have a fundamental understanding of the various types of risks associated with different aspects of the banking business, for example, credit risk, foreign-exchange risk, or interest-rate risk, and define the types of risks the bank will undertake. Some of the more important areas in which policies and objectives must be established include investments, loans, asset and liability management, profit planning and budgeting, capital planning, and personnel. Directors are also responsible for adopting policies and procedures required by law or regulation, such as real estate lending policies, a security program, an interbank liabilities policy, and a Bank Secrecy Act program. The examination of these policies is covered in other sections of this manual.

Avoidance of Self-Serving Practices

A bank's directors bear a greater than normal responsibility for upholding safe and sound practices in dealing with transactions involving other members of the directorate and their related interests. Directors' decisions must preclude the possibility of partiality or favored treatment. Unwarranted loans to a bank's directors or their interests can be a serious safety-and-soundness concern for the bank. Directors who become financially dependent on their bank normally lose their usefulness as directors. Other self-serving practices the examiner should watch for are—

- gratuities paid to directors to obtain their approval of financing arrangements or the use of particular services,
- the use of bank funds by directors, officers, or shareholders to obtain loans or transact other business (Directors should be especially critical of correspondent bank balances when officers, directors, or shareholders are borrowing from the depository bank. The Department of Justice's position is that certain interbank deposits connected with a loan to officers, directors, or shareholders of the depositing bank might constitute a misapplication of funds in violation of 18 USC 656), and
- transactions involving conflicts of interest (When board decisions involve a potential conflict of interest, the director with the potential conflict should fully disclose the nature of the conflict and abstain from voting on the matter. The abstention should be recorded in the minutes. The examiner should also be aware that ethical conflicts of interest can arise when a director or director-related firm performs professional services for the bank. For example, a director who is also the bank's legal counsel may not, in some situations, be able to advise or represent the bank objectively.).

Awareness of the Bank's Financial Condition and Management Policies

Management Information Systems

A management information system (MIS) provides the information, often originated from an institution's mainframe and microcomputers, necessary to manage an organization effectively. MIS should have clearly defined guidelines, policies, practices, standards, and procedures for the organization. These should be incorporated in the development, maintenance, and use of MIS throughout the institution.

MIS is used by all levels of bank staff to monitor various aspects of bank operations, up to and including its overall risk-management process. Therefore, MIS should be supportive of the institution's longer term strategic goals and objectives. At the other extreme, these everyday financial accounting systems also are used to ensure that basic control is maintained over financial recordkeeping activities. Since numerous decisions are based on MIS reports, appropriate control procedures must be set up to ensure that information is correct and relevant.

Audits

In May 1993, pursuant to requirements of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the FDIC issued rules and guidelines that require all banks with total assets in excess of $500 million to have annual audits by an independent public accountant. Copies of these audit reports are to be sent to the FDIC and the appropriate Federal Reserve Bank. Furthermore, the Federal Reserve encourages banks with assets of $500 million or less to provide for annual audits by independent public accountants.

The board or a committee designated by the board should review the audit reports with the bank's management and the independent public accountants. The review should include—

- the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;
- the adequacy of internal controls, and actions necessary to ensure the resolution of any problems or deficiencies; and
- the institution's compliance with applicable laws and regulations.

Many states have laws requiring directors' examinations of the bank. When the directors lack adequate knowledge of examination techniques and procedures, they are encouraged to employ a qualified accountant or other specialist to conduct all or part of this examination. The examining committee or the entire board should play an active role. Directors should obtain a clear understanding of the scope of the procedures to be employed, and the final report of the directors' examination should be reviewed by the board of directors.

Further guidance on the use of audit reports and the reliance placed upon the work of external and internal auditors in the examination process can be found in the "Internal and External Audit Section" of this manual.

Maintenance of Reasonable Capitalization

A board of directors has the responsibility for maintaining its bank on a sufficiently capitalized basis. Capital planning and capital adequacy are discussed in the manual section "Assessment of Capital Adequacy," and the examiner should be familiar with this information.

Compliance with Banking Laws and Regulations

Directors must carefully observe that banking laws are not violated; they may be personally liable for losses arising out of illegal actions. In addition, civil money penalties can be assessed for unsafe and unsound actions that do not necessarily involve a violation of a banking law.

Guarantee of a Beneficial Influence on the Community's Economy

One reason for approving a newly chartered bank for Federal Reserve membership is to meet a specific community need. Directors, therefore, have a continuing responsibility to provide those banking services which meet the legitimate credit and other needs of the community being served. Directors should be certain that the bank attempts to satisfy all legitimate credit needs of the community.

BOARD MEETINGS

The board should conduct its business in meetings held as required by the bank's bylaws or state law. Regular meetings of the board should review statements showing the bank's financial condition and earnings; the investment portfolio; and loan activity, including past-due and nonaccrual loans, charged-off or recovered loans, large new loans, and loans to insiders. Directors should also review and approve all policies annually, and review and approve all insurance policies as they are obtained or renewed. They should also review audit and examination reports and initiate action to correct any deficiencies noted, review correspondence with regulatory agencies, review pending litigation, and keep informed of any major prospective undertakings, such as mergers, acquisitions, or new branches or construction.

Minutes of Board Meetings

The board should ensure that an accurate, adequate record of its actions is maintained. Such a record is usually kept in the form of minutes of the board meetings. The minutes should document the board's review of all regular items mentioned above as well as the review and discussion of all significant items that are not part of the regular meeting. Additionally, at a minimum, the minutes should record the attendance or absence of each director at each meeting, detail the establishment and composition of any committees, and note the abstention of any director from any vote. Examiners should review the minutes of board meetings, as well as a sample package prepared for a board meeting, to determine that directors are receiving adequate information to make informed, sound decisions. Meetings conducted by telephone, if allowable under state law, should be documented as thoroughly as regular meetings.

BOARD COMMITTEES

Many boards elect to delegate some of their workload to committees. The extent and nature of the bank's activities and the relative expertise of each board member play key roles in the board's determination of which committees to establish, who sits on them, and how much authority they have. Thus, there is no ideal committee structure. However, committees frequently found in state member banks include the following:

- *Executive Committee*—may be empowered to act when the full board is unable to meet, for example, between regular meetings. An executive committee is usually found in large institutions, where it relieves the full board of the burden of reviewing the details of financial statements and operational activities.

- *Audit Committee*—typically monitors compliance with bank policies and procedures, and reviews internal and external audit reports and bank examination reports. Because it is responsible for ensuring compliance, accuracy, and integrity throughout the organization, the audit committee should consist only of outside directors. The audit committee may supervise the bank's internal auditor and his or her staff directly by hiring personnel, evaluating their performance, and setting their compensation.
- *Loan Committee*—may be established to monitor underwriting standards and loan quality, and to ensure that lending policies and procedures are adequate. In most banks with loan committees, all new loans are reviewed by the loan committee either before or after funding, with the threshold for prior approval being the amount of either the loan or the aggregate debt to the borrower. The loan committee may also be responsible for the loan review function and for maintaining an adequate reserve for loan losses.
- *Investment or Asset-Liability Management Committee*—monitors the bank's investment policies, procedures, and holdings portfolio to ensure that goals for diversification, credit quality, profitability, liquidity, community investment, pledging requirements, and regulatory compliance are met. In some banks whose complexity warrants it, asset-liability management committees have been established to replace or supplement investment committees. An asset-liability management committee monitors the bank's balance sheet and external forces, notably interest rates, to help coordinate asset acquisition and funding sources.
- *Other Committees*—depending on the nature and complexity of the bank's business, the board may establish other committees to monitor such areas as trust, branching, new facilities construction, personnel/human resources, electronic data processing, and consumer compliance.

Minutes of all major actions taken by committees that play a significant role in managing the bank should be kept and meet the same minimum standards used for minutes of meetings of the full board.

COMPLIANCE WITH FORMAL AND INFORMAL SUPERVISORY ACTIONS

Bank directors must ensure that management corrects deficiencies found in the bank. Instructions to do so may come from the Federal Reserve as a formal or informal supervisory action, depending on the severity of the problem.

Formal actions, which include cease-and-desist orders and written agreements, are normally exercised when banks have serious problems. For less serious problems, the Federal Reserve issues informal actions such as a "memorandum of understanding." Informal actions are an agreement between the Reserve Bank and the bank that sets forth the required corrective actions. The Reserve Banks are generally responsible for monitoring compliance with both types of supervisory actions. To assist in that process, the Reserve Bank normally receives and evaluates periodic progress reports from the bank. In addition, information is provided by the examiner, who checks the bank's compliance with the action. The Reserve Banks may initiate additional supervisory action against the bank or individuals associated with it when compliance is insufficient.

Examiners should briefly discuss compliance with any enforcement actions on the Examination Conclusions and Comments page and direct the board of directors' attention to the Compliance with Enforcement Actions page of the examination report. The type and date of the action or resolutions and parties to the action should be listed. In addition, the examiner should generally list each provision requiring action by the bank and provide a comment addressing compliance with that provision. The examiner should comment on how the bank accomplished compliance or the problems that have prevented compliance. While certain information might be better discussed in the confidential section of the report, it is appropriate to make all salient negative comments on the Compliance with Enforcement Actions page to ensure that bank directors are notified of the remaining deficiencies that need to be corrected.

The Reserve Bank may recommend termination or modification of a formal supervisory action whenever it determines that the action has satisfactorily served its purpose and should be removed or modified. In these cases, the Reserve

Bank will send a memorandum with the appropriate explanation to the Board's Division of Supervision and Regulation (S&R) for review and evaluation. S&R and the Board's Legal Division, when appropriate, will prepare the documents necessary to terminate or modify the existing formal supervisory action.

Duties and Responsibilities of Directors
Examination Objectives
Effective date November 1995

Section 4000.2

1. To determine whether the board of directors fully understands its duties and responsibilities.
2. To determine if the board of directors is discharging its responsibilities in an appropriate manner.
3. To determine whether the board of directors has developed adequate objectives and policies.
4. To determine the existence of any conflicts of interest or self-dealing.
5. To determine compliance with laws and regulations.

1. Update the following and review for possible violations of law—
   a. A list of directors to include—
      - home address (If the director was appointed or elected since the previous examination, state the number of years residing at present address.),
      - date of birth,
      - years as a director of the bank,
      - approximate net worth,
      - occupation,
      - citizenship,
      - common stock ownership (beneficial, direct, and indirect), and
      - bonuses, fees, etc.
   b. A list of embezzlements, defalcations, misappropriations, mysterious disappearances, or thefts that have occurred since the last examination. That list should be signed by the chief executive officer or the auditor.
   c. A list of management officials (as defined in the Depository Institution Management Interlocks Act) of the bank, its holding company, and holding company affiliates who are management officials of other depository institutions.
   d. A list of the indebtedness of directors, executives officers, and principal shareholders to the bank examined and any other bank, along with a statement of the terms and conditions of each extension of credit.
2. Obtain or update a listing of all areas of the bank's operations that are administered under the provisions of written objectives and policies that have been developed by or with the approval of the board. Inform the examiners assigned to review those departments that a policy has been developed or an update has occurred.
3. Analyze the listing obtained in step 2, and note any area of banking activity for which policies should be developed.
4. Determine that the board has accepted its responsibility to effectively supervise the affairs of the bank and to be informed of the bank's condition by performing the following:
   a. Obtain a complete set of the latest reports furnished to directors at the last meeting, and list the areas of operation covered by the reports.
   b. Distribute copies of the reports to the examiners in other areas, and request that they determine if reports furnished to the board are prepared accurately, contain sufficient detail to allow the directors to make an intelligent decision, and are submitted on a timely basis.
   c. Prepare a list of areas not reporting or of reports the board does not receive that are considered necessary to maintain adequate supervision. As guidelines, consider the following reports:
      - A monthly statement of condition or balance sheet and a monthly statement of income. Those statements should be in reasonable detail and should be compared with the prior month, with the same month of a prior year, and with the budget. The directors should receive explanations for all large variances.
      - Monthly statements of changes in all capital and reserve accounts. Such statements should explain any changes.
      - Investment reports that group the securities by classifications; that reflect the book value, fair market value, and yield; and that include a summary of purchases and sales.
      - Loan reports that list significant past-due loans, trends in delinquencies, rate reductions, non-income-producing loans, and large new loans granted since the last report.
      - Audit and examination reports. Deficiencies in these reports should produce a prompt and efficient response from the board. The reports reviewed and actions taken should be reflected in minutes of the board of directors meetings.
      - A full report of all new executive-officer borrowing at any bank.
      - A monthly listing of type and amount of borrowing by the bank.
      - An annual presentation of bank insurance coverage.

- All correspondence addressed to the board of directors from the Federal Reserve and any other source.
- A monthly analysis of the bank's liquidity position.
- An annual projection of the bank's capital needs.
- A listing of any new litigation and a status report on existing litigation and potential exposure.
- A thorough report on any major bank endeavor that each bank director is expected to make a decision on, including branch applications and major building plans.

d. Determine the mechanism used to assign responsibility for correcting deficiencies noted in regulatory reports, internal audit reports, external audit reports, or any other reports to the board, and determine the board's system of determining compliance with such recommendations.

e. Determine how directors perform a director's examination, the frequency of such examinations, and what part the directors take in the process.

f. Review the bank's method of ensuring continued or resumed operations in the event of a disaster. Complete the emergency preparedness measures questionnaire for inclusion in the workpapers.

g. Review correspondence between the Federal Reserve and the bank to determine that it has been properly reported.

5. Determine evidence of conflicts of interest and self-dealing by—
   a. obtaining and summarizing information on the business interests of directors, executive officers, and principal shareholders;
   b. comparing that information to develop a list of directors who have business interests in common;
   c. analyzing the interests of directors to determine if the board consists of a variety of individuals;
   d. obtaining from the examiner assigned to assessment of capital adequacy a list of shareholders who own or control, either directly or indirectly, 5 percent or more of any class of voting security;
   e. distributing a list of the insiders (directors, officers, and shareholders whose ownership of voting securities in the institution is more than 10 percent) and their related interests to the appropriate examining personnel to ascertain the extent of loans to or transactions with insiders and their interests (Those examiners should be alert for any relationships with insiders' interests that are not included on the list.);
   f. requesting that the appropriate examiners determine if any transactions with insiders are on terms more favorable than those offered to other customers (If so, determine whether the board has approved such transactions.);
   g. determining that directors have reviewed their correspondent bank accounts in relation to possible conflicts of interest arising from directors', officers', or shareholders' borrowing from depository banks; and
   h. correlating all information on insider transactions, and preparing appropriate report comments.
6. Obtain the minutes of the meetings of the board of directors, the charter, the bylaws, and the minutes of shareholders meetings.
   a. Review and summarize the bylaws and charter of the organization, including any specific provisions on the requirements of directors. The resulting material should become a permanent part of the workpapers and should be updated at subsequent examinations.
   b. Read and summarize the minutes of all meetings of the board since the last examination, making certain to—
      - list any actions taken in contravention of the bylaws;
      - record major actions taken by the board that are not a part of a normal monthly meeting;
      - record any resolution or discussion covering the development of or entrance into a new area, such as a geographic area, customer service, asset category, or liability category;
      - record the creation of any special committee and the area with which it is designed to deal;
      - determine that actions taken by standing committees are reviewed and ratified by the full board;
      - if the minutes specify any transactions with directors or their interests, deter-

mine that the abstention of any interested director from voting on the matters is noted;
- if the minutes do not mention any director-related transactions that have been uncovered during the examination, inquire if the interested director did refrain from voting.

c. Read and summarize the minutes of the board's annual organization meeting and—
- list standing committees and their members,
- have examiners who are examining areas that have standing-committee supervision read and summarize the minutes of those committees, and
- prepare a list of major areas of operation that are not monitored by specific committees.

d. Read and summarize the minutes of any stockholders meetings. The summary should include a list of directors elected at the annual meeting, the number of shares present and voted, individuals acting as proxies, and specific action approved by shareholders.

e. Ascertain during the review of shareholders meeting minutes that (1) shareholders' approval has been received; (2) the bank's charter has been amended, if necessary; and (3) compliance with appropriate state or federal statutes has been met for the following:
- any establishment of or change of a branch location
- any issuance of preferred stock
- any increase in capital stock, either through sale or a stock dividend
- any reduction in capital stock (and ascertain whether the resultant capital is not below what is required by the capital adequacy guidelines)
- any stock split
- any bank pension plan established since the preceding examination
- any bank involvement in a conversion, merger, or consolidation
- all other matters subject to vote

f. Determine the date of the annual shareholders meeting and if it was in compliance with the bylaws.

g. Review the charter and/or bylaws for quorum requirements of shareholder meetings. Ascertain that, at any meeting, the quorum requirements were satisfied according to recorded requirements or by having more than one-half of the eligible shareholders represented.

h. Review any stock option or stock purchase plan adopted since the preceding examination, and review such action for compliance with the various conditions involving charter and shareholder approval.

i. Determine if any candidate was nominated for director, other than the slate nominated by bank management, and review for compliance with the appropriate state statute.

7. Determine that the directors have accepted their responsibility for selecting competent officers by—
   a. determining that the board or a committee thereof reviews, at least annually, the chief executive officer's performance in attaining or progressing toward attaining specific objectives or goals set by the board,
   b. determining if a policy statement on personnel exists, and ascertaining what provisions the board has made for successor management,
   c. determining if any management contracts exist and, if one does, obtaining a copy, summarizing the pertinent points, and determining the reasonableness of terms,
   d. determining by inquiry how the remuneration of executive officers is set and who makes decisions concerning executive salaries, and
   e. listing any titled individual who, by action of the board, is specifically excluded from being an executive officer.
8. Determine compliance with laws and regulations by—
   a. reviewing workpapers of other examination areas or discussing compliance with other examiners to determine any violations of laws or regulations concerning directors that were disclosed in these examination areas,
   b. reviewing the nature and extent of violations discovered at prior examinations to determine if similar violations have occurred at this examination, and
   c. correlating information obtained from the minutes of board meetings to the reports of officer borrowings that have

been prepared at and forwarded from other banks to determine that all such borrowings have been reported to the board.

9. Determine compliance with the Foreign Corrupt Practices Act (15 USC 78dd-1 and -2) by—
   a. reviewing the bank's policy prohibiting improper or illegal payments, bribes, kickbacks, etc., to any foreign government official or other person or organization covered by the law;
   b. determining how that policy has been communicated to officers, employees, or agents of the bank;
   c. reviewing any investigation or study done by, or on behalf of, the board of directors on the bank's policies and operations concerning the advance of funds in possible violation of the act;
   d. reviewing the work done by the examiner assigned to internal control to determine whether internal or external auditors have established routines to discover improper or illegal payments;
   e. analyzing the general level of internal control to determine whether there is sufficient protection against the inaccurate recording of improper or illegal payments on the bank's books;
   f. requesting that examiners working in other areas of the bank be alert for any transactions that might violate the provisions of the act;
   g. compiling any information discovered throughout the examination on possible violations; and
   h. performing procedures on suspected criminal violations as outlined in section 5020.3, "Overall Conclusions Regarding Condition of the Bank: Examination Procedures."
10. Answer the following questions. (This questionnaire is intended to be a quick review for determining that all laws and regulations pertaining to directors have been complied with. Questions should be answered "no" and sub-questions should be answered "yes." Any deviation from this pattern indicates a violation or potential violation. Situations that are not judged to be violations require comments stating the basis for that judgment.)
    a. Is the number of directors less than 5 or greater than 25 (section 31, Banking Act of June 16, 1933)?
    b. Have any directors failed to qualify by reason of insufficient stock ownership (12 USC 72)?
    c. Are any directors noncitizens of the United States (12 USC 72)? If so, has the citizenship requirement been waived?
    d. Do more than one-third of the directors fail to reside in the state, territory, or district in which the bank is located, or within 100 miles of the bank's head office (12 USC 72)?
    e. Did more than one-third of the directors fail to reside in the state, territory or district in which the bank is located, or within 100 miles of the bank's head office, for one year before election (12 USC 72)?
    f. Are any transactions with directors or their related interests on more favorable terms than those offered to other customers (Regulation O (12 CFR 215))?
    g. Do the deposit accounts of directors receive greater interest than those of other customers (section 22(e), Federal Reserve Act (12 USC 376))?
    h. Have any provisions of a cease-and-desist agreement or order been violated (Rules of Practice for Hearings (12 CFR 263))?
    i. Has any director, officer, or employee been convicted of a crime involving a breach of trust or act of dishonesty (section 8(g) of the Federal Deposit Insurance Act (12 USC 1829))? If so, has the FDIC approved his or her membership on the board or employment?
    j. Have any tie-ins of services been authorized by the board (Regulation Y (12 CFR 225.7))?
    k. Were any loans to bank examiners disclosed (Criminal Code—18 USC 212 and 213)?
    l. Has the bank made any political contributions (Federal Election Campaign Act (12 USC 441b))?
    m. Have any employees been found to have misappropriated funds, made false entries, or otherwise defrauded the bank (18 USC 656)?
    n. Has an officer of the bank failed to make appropriate written reports when an

embezzlement, misapplication, or similar transaction occurred (SR-579)?

o. Have any extortionate extensions of credit been discovered (18 USC 892–894)?
p. Have any checks been certified against uncollected funds (18 USC 1004)?
q. Have unauthorized obligations of the bank been issued (18 USC 1005 and 1006)?
r. Has there been a change in control (Regulation Y (12 CFR 225.41–225.43))? If so, was the Federal Reserve notified and was the application approved?
s. Have any purchase-money loans been made that are secured by 25 percent or more of the stock of another secured bank (Regulation Y (12 CFR 225.41))? If so, have the appropriate authorities been notified?
t. Has the bank failed to maintain records of directors, executive officers, and principal shareholders and their related interests (Regulation O (12 CFR 215.8))?
u. Are management officials of the bank, or its holding company or holding company affiliates, also management officials of an unaffiliated depository institution or depository holding company (Regulation L (12 CFR 212))? If so—
   - was such relationship established prior to November 10, 1978, and previously permitted by section 8, Clayton Anti-Trust Act (15 USC 19)?
   - was prior approval of the Federal Reserve obtained for a relationship that was developed since November 10, 1978?
   - does the interlocking relationship meet the criteria of one of the exceptions permitted by Regulation L (12 CFR 212)?
   - is the management relationship with an institution whose—
     — principal offices or branches, excluding electronic terminals, are located in a different RMSA from the bank's or its holding company's offices or branches (does not apply if either institution has assets of less than $20 million) (12 CFR 212.3(b))?
     — principal offices or branches, excluding electronic terminals, are located in another city, town, or village not contiguous or adjacent and 10 miles or more apart?
   - if the bank or its holding company has assets exceeding $2.5 billion, does the interlocking management relationship exist with a nonaffiliated depository institution holding company with assets of $1.5 billion or less?

v. Have any loans to executive officers been uncovered that were not reported to the board (Regulation O (12 CFR 215) and 12 USC 503)?
w. Has a majority of the board failed to preapprove extensions of credit to any of the bank's executive officers, directors, or principal shareholders and their related interests when the total loans to the individual exceed the amount prescribed in Regulation O?
x. Has the bank notified executive officers and principal shareholders of their reporting requirements (Regulation O (12 CFR 215))?

11. Determine compliance with administrative actions by—
    a. reviewing provisions of the document and
    b. reviewing bank records and performing necessary procedures to isolate noncompliance.
12. Evaluate the bank's compliance with formal or informal administrative actions and prepare comments for page one of the examination report (SR-02-17 and SR-92-21). (See also section 5040.1.)
13. Determine compliance with conditions imposed in the approvals of corporate filings for—
    a. branches and relocation applications, including—
       - capital plans or capital injections,
       - fixed-asset limitations, and
       - CRA plans;
    b. subordinated debt, operating subsidiaries, and interim bank applications, including—
       - capital plans and
       - prior review and appropriate clearance of disclosures.
14. On the basis of the information obtained by performing the foregoing procedures, or any other procedures deemed appropriate, evaluate the adequacy and effectiveness of the board of directors. The evaluation should include, but is not limited to—

a. the frequency and effectiveness of meetings;
b. the effectiveness of board committees;
c. the directors' role in establishing policy;
d. the adequacy of the policies and major inconsistencies therein;
e. the quality of reports for directors, noting any deficiencies in information flows from operating management;
f. violations of laws and regulations;
g. whether any one person or group appears to control or dominate the board (if so, comment on any adverse effects on operating policies, procedures, or the overall financial condition of the bank); and
h. the board's responsiveness to recommendations from the auditors and supervisory authorities.

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

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 financial statements, including its earnings and capital position.

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[1] and the current rate of return on high-quality fixed-income debt securities[2] 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

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:

Expected retirement age	60
Number of years to expected retirement age	5
Discount rate (%)	6.75
Expected mortality age based on present age	70

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:

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

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:

	Debit	*Credit*
Compensation expense	$102,514	
Deferred compensation liability		$102,514

[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 in each period after the inception of the agreement, and revise the assumptions and rate, as appropriate.

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:

	Debit	Credit
Compensation expense	$6,920	
Deferred compensation liability		$6,920

[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:

	Debit	Credit
Deferred compensation liability	$20,000	
Cash		$20,000

[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:

Expected retirement age	60
Number of years to expected retirement age	5
Discount rate (%)	6.75
Expected mortality age based on present age	70

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

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

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:

	Debit	*Credit*
Compensation expense	$24,835	
Deferred compensation liability		$24,835

[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:

	Debit	*Credit*
Compensation expense	$1,676	
Deferred compensation liability		$1,676

[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:

	Debit	*Credit*
Deferred compensation liability	$20,000	
Cash		$20,000

[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.

Incentive compensation practices in the financial industry were one of many factors that contributed to the financial crisis that began in mid-2007. Banking organizations too often rewarded employees for increasing the organization's revenue or short-term profit without adequate recognition of the risks the employees' activities posed to the organization.[1] These practices exacerbated the risks and losses at a number of banking organizations and resulted in the misalignment of the interests of employees with the long-term well-being and safety and soundness of their organizations. This section provides guidance on sound incentive compensation practices to banking organizations supervised by the Federal Reserve (also the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the ''Agencies'')).[2] This guidance is intended to assist banking organizations in designing and implementing incentive compensation arrangements and related policies and procedures that effectively consider potential risks and risk outcomes.[3]

Alignment of incentives provided to employees with the interests of shareholders of the organization often also benefits safety and soundness. However, aligning employee incentives with the interests of shareholders is not always sufficient to address safety-and-soundness concerns. Because of the presence of the federal safety net (including the ability of insured depository institutions to raise insured deposits and access the discount window and payment services of the Federal Reserve), shareholders of a banking organization in some cases may be willing to tolerate a degree of risk that is inconsistent with the organization's safety and soundness. Accordingly, the Federal Reserve expects banking organizations to maintain incentive compensation practices that are consistent with safety and soundness, even when these practices go beyond those needed to align shareholder and employee interests.

To be consistent with safety and soundness, incentive compensation arrangements[4] at a banking organization should:

1. Provide employees incentives that appropriately balance risk and reward;
2. Be compatible with effective controls and risk-management; and
3. Be supported by strong corporate governance, including active and effective oversight by the organization's board of directors.

These principles, and the types of policies, procedures, and systems that banking organizations should have to help ensure compliance with them, are discussed later in this guidance.

The Federal Reserve expects banking organizations to regularly review their incentive compensation arrangements for all executive and non-executive employees who, either individually or as part of a group, have the ability to expose the organization to material amounts of risk, as well as to regularly review the risk-management, control, and corporate governance processes related to these arrangements. Banking organizations should immediately address any identified deficiencies in these arrangements or processes that are inconsistent with safety and soundness. Banking organizations are responsible for ensuring that their incentive compensation arrangements are consistent with the prin-

1. Examples of risks that may present a threat to the organization's safety and soundness include credit, market, liquidity, operational, legal, compliance, and reputational risks.

2. As used in this guidance, the term ''banking organization'' includes national banks, state member banks, state nonmember banks, savings associations, U.S. bank holding companies, savings and loan holding companies, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs) with a branch, agency, or commercial lending company in the United States. If the Federal Reserve is referenced, the reference is intended to also include the other supervisory Agencies.

3. This guidance (see 75 *Fed. Reg.* 36395, June 25, 2010, for the entire text) and the principles reflected herein are consistent with the *Principles for Sound Compensation Practices* issued by the Financial Stability Board (FSB) in April 2009, and with the FSB's *Implementation Standards* for those principles, issued in September 2009.

4. In this guidance, the term ''incentive compensation'' refers to that portion of an employee's current or potential compensation that is tied to achievement of one or more specific metrics (e.g., a level of sales, revenue, or income). Incentive compensation does not include compensation that is awarded solely for, and the payment of which is solely tied to, continued employment (e.g., salary). In addition, the term does not include compensation arrangements that are determined based solely on the employee's level of compensation and does not vary based on one or more performance metrics (e.g., a 401(k) plan under which the organization contributes a set percentage of an employee's salary).

ciples described in this guidance and that they do not encourage employees to expose the organization to imprudent risks that may pose a threat to the safety and soundness of the organization.

The Federal Reserve recognizes that incentive compensation arrangements often seek to serve several important and worthy objectives. For example, incentive compensation arrangements may be used to help attract skilled staff, induce better organization-wide and employee performance, promote employee retention, provide retirement security to employees, or allow compensation expenses to vary with revenue on an organization-wide basis. Moreover, the analysis and methods for ensuring that incentive compensation arrangements take appropriate account of risk should be tailored to the size, complexity, business strategy, and risk tolerance of each organization. The resources required will depend upon the complexity of the firm and its use of incentive compensation arrangements. For some, the task of designing and implementing compensation arrangements that properly offer incentives for executive and non-executive employees to pursue the organization's long-term well-being and that do not encourage imprudent risk-taking is a complex task that will require the commitment of adequate resources.

While issues related to designing and implementing incentive compensation arrangements are complex, the Federal Reserve is committed to ensuring that banking organizations move forward in incorporating the principles described in this guidance into their incentive compensation practices.[5]

As discussed further below, because of the size and complexity of their operations, large complex banking organizations (LCBOs)[6] should have and adhere to systematic and formalized policies, procedures, and processes. These are considered important in ensuring that incentive compensation arrangements for all covered employees are identified and reviewed by appropriate levels of management (including the board of directors where appropriate and control units), and that they appropriately balance risks and rewards. In several places, this guidance specifically highlights the types of policies, procedures, and systems that LCBOs should have and maintain but that generally are not expected of smaller, less complex organizations. LCBOs warrant the most intensive supervisory attention because they are significant users of incentive compensation arrangements and because flawed approaches at these organizations are more likely to have adverse effects on the broader financial system. The Federal Reserve will work with LCBOs as necessary through the supervisory process to ensure that they promptly correct any deficiencies that may be inconsistent with the safety and soundness of the organization.

The policies, procedures, and systems of smaller banking organizations that use incentive compensation arrangements[7] are expected to be less extensive, formalized, and detailed than those of LCBOs. Supervisory reviews of incentive compensation arrangements at smaller, less-complex banking organizations will be conducted by the Federal Reserve as part of the evaluation of those organizations' risk-management, internal controls, and corporate governance during the regular, risk-focused examination process. These reviews will be tailored to reflect the scope and complexity of an organization's activities, as well as the prevalence and scope of its incentive compensation arrangements. Little, if any, additional examination work is expected for smaller banking organizations that do not use, to a significant extent, incentive compensation arrangements.[8]

5. In December 2009, the Federal Reserve, working with the other Agencies, initiated a special horizontal review of incentive compensation arrangements and related risk-management, control, and corporate governance practices of large banking organizations (LBOs). This initiative was designed to spur and monitor the industry's progress towards the implementation of safe and sound incentive compensation arrangements, identify emerging best practices, and advance the state of practice more generally in the industry.

6. For supervisory purposes, the Federal Reserve (as well as the other federal bank regulatory agencies) segments the organizations it supervises into different supervisory portfolios based on, among other things, size, complexity, and risk profile. For purposes of this guidance, the LBOs referred to in the guidance are identified in this section as large complex banking organizations to be consistent with the Federal Reserve's other supervisory policies. LBOs are designated by (1) the OCC as the largest and most complex national banks as defined in the Large Bank Supervision booklet of the Comptroller's Handbook; (2) the FDIC, large, complex insured depository institutions (IDIs); and (3) the OTS, the largest and most complex savings associations and savings and loan holding companies.

7. This guidance does not apply to banking organizations that do not use incentive compensation.

8. To facilitate these reviews, where appropriate, a smaller banking organization should review its compensation arrangements to determine whether it uses incentive compensation arrangements to a significant extent in its business operations. A smaller banking organization will not be considered a significant user of incentive compensation arrangements simply because the organization has a firm-wide profit-sharing or

For all banking organizations, supervisory findings related to incentive compensation will be communicated to the organization and included in the relevant report of examination or inspection. In addition, these findings will be incorporated, as appropriate, into the organization's rating component(s) and subcomponent(s) relating to risk-management, internal controls, and corporate governance under the relevant supervisory rating system, as well as the organization's overall supervisory rating.

The Federal Reserve (or the organization's appropriate federal supervisor) may take enforcement action against a banking organization if its incentive compensation arrangements or related risk-management, control, or governance processes pose a risk to the safety and soundness of the organization, particularly when the organization is not taking prompt and effective measures to correct the deficiencies. For example, the appropriate federal supervisor may take an enforcement action if material deficiencies are found to exist in the organization's incentive compensation arrangements or related risk-management, control, or governance processes, or the organization fails to promptly develop, submit, or adhere to an effective plan designed to ensure that its incentive compensation arrangements do not encourage imprudent risk-taking and are consistent with principles of safety and soundness. As provided under section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818), an enforcement action may, among other things, require an organization to take affirmative action, such as developing a corrective action plan that is acceptable to the appropriate federal supervisor to rectify safety-and-soundness deficiencies in its incentive compensation arrangements or related processes. Where warranted, the appropriate federal supervisor may require the organization to take additional affirmative action to correct or remedy deficiencies related to the organization's incentive compensation practices.

Effective and balanced incentive compensation practices are likely to evolve significantly in the coming years, spurred by the efforts of banking organizations, supervisors, and other stakeholders. The Federal Reserve will review and update this guidance as appropriate to incorporate best practices that emerge from these efforts.

bonus plan that is based on the bank's profitability, even if the plan covers all or most of the organization's employees.

SCOPE OF APPLICATION

The incentive compensation arrangements and related policies and procedures of banking organizations should be consistent with principles of safety and soundness.[9] Incentive compensation arrangements for executive officers as well as for non-executive personnel who have the ability to expose a banking organization to material amounts of risk may, if not properly structured, pose a threat to the organization's safety and soundness. Accordingly, this guidance applies to incentive compensation arrangements for:

1. Senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;[10]
2. Individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk (e.g., traders with large position limits relative to the organization's overall risk tolerance); and
3. Groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk (e.g., loan officers who, as a group, originate loans that account for a material amount of the organization's credit risk).

For ease of reference, these executive and non-executive employees are collectively referred to hereafter as "covered employees" or "employees." Depending on the facts and circumstances of the individual organization, the

9. In the case of the U.S. operations of FBOs, the organization's policies, including management, review, and approval requirements for its U.S. operations, should be coordinated with the FBO's group-wide policies developed in accordance with the rules of the FBO's home country supervisor. The policies of the FBO's U.S. operations should also be consistent with the FBO's overall corporate and management structure, as well as its framework for risk-management and internal controls. In addition, the policies for the U.S. operations of FBOs should be consistent with this guidance.

10. Senior executives include, at a minimum, "executive officers" within the meaning of the Federal Reserve's Regulation O (see 12 CFR 215.2(e)(1)) and, for publicly traded companies, "named officers" within the meaning of the Securities and Exchange Commission's rules on disclosure of executive compensation (see 17 CFR 229.402(a)(3)). Savings associations should also refer to the OTS's rule on loans by savings associations to their executive officers, directors, and principal shareholders. (12 CFR 563.43).

types of employees or categories of employees that are outside the scope of this guidance because they do not have the ability to expose the organization to material risks would likely include, for example, tellers, bookkeepers, couriers, or data processing personnel.

In determining whether an employee, or group of employees, may expose a banking organization to material risk, the organization should consider the full range of inherent risks arising from, or generated by, the employee's activities, even if the organization uses risk-management processes or controls to limit the risks such activities ultimately may pose to the organization. Moreover, risks should be considered to be material for purposes of this guidance if they are material to the organization, or are material to a business line or operating unit that is itself material to the organization.[11]

For purposes of illustration, assume that a banking organization has a structured-finance unit that is material to the organization. A group of employees within that unit who originate structured-finance transactions that may expose the unit to material risks should be considered "covered employees" for purposes of this guidance even if those transactions must be approved by an independent risk function prior to consummation, or the organization uses other processes or methods to limit the risk that such transactions may present to the organization.

Strong and effective risk-management and internal control functions are critical to the safety and soundness of banking organizations. However, irrespective of the quality of these functions, poorly designed or managed incentive compensation arrangements can themselves be a source of risk to a banking organization. For example, incentive compensation arrangements that provide employees strong incentives to increase the organization's short-term revenues or profits, without regard to the short- or long-term risk associated with such business, can place substantial strain on the risk-management and internal control functions of even well-managed organizations.

Moreover, poorly balanced incentive compensation arrangements can encourage employees to take affirmative actions to weaken or circumvent the organization's risk-management or internal control functions, such as by providing inaccurate or incomplete information to these functions, to boost the employee's personal compensation. Accordingly, sound compensation practices are an integral part of strong risk-management and internal control functions. A key goal of this guidance is to encourage banking organizations to incorporate the risks related to incentive compensation into their broader risk-management framework. Risk-management procedures and risk controls that ordinarily limit risk-taking do not obviate the need for incentive compensation arrangements to properly balance risk-taking incentives.

11. Thus, risks may be material to an organization even if they are not large enough themselves to threaten the solvency of the organization.

PRINCIPLES OF A SOUND INCENTIVE COMPENSATION SYSTEM

Principle 1: Balanced Risk-Taking Incentives

Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks.

Incentive compensation arrangements typically attempt to encourage actions that result in greater revenue or profit for the organization. However, short-run revenue or profit can often diverge sharply from actual long-run profit because risk outcomes may become clear only over time. Activities that carry higher risk typically yield higher short-term revenue, and an employee who is given incentives to increase short-term revenue or profit, without regard to risk, will naturally be attracted to opportunities to expose the organization to more risk.

An incentive compensation arrangement is balanced when the amounts paid to an employee appropriately take into account the risks (including compliance risks), as well as the financial benefits, from the employee's activities and the impact of those activities on the organization's safety and soundness. As an example, under a balanced incentive compensation arrangement, two employees who generate the same amount of short-term revenue or profit for an organization should not receive the same amount of incentive compensation if the risks taken by the employees in generating that revenue or profit differ materially. The employee whose activities create materially larger risks for the organization should receive less than the other employee, all else being equal.

The performance measures used in an incentive compensation arrangement have an important effect on the incentives provided employees and, thus, the potential for the arrangement to encourage imprudent risk-taking. For example, if an employee's incentive compensation payments are closely tied to short-term revenue or profit of business generated by the employee, without any adjustments for the risks associated with the business generated, the potential for the arrangement to encourage imprudent risk-taking may be quite strong. Similarly, traders who work with positions that close at year-end could have an incentive to take large risks toward the end of a year if there is no mechanism for factoring how such positions perform over a longer period of time. The same result could ensue if the performance measures themselves lack integrity or can be manipulated inappropriately by the employees receiving incentive compensation.

On the other hand, if an employee's incentive compensation payments are determined based on performance measures that are only distantly linked to the employee's activities (e.g., for most employees, organization-wide profit), the potential for the arrangement to encourage the employee to take imprudent risks on behalf of the organization may be weak. For this reason, plans that provide for awards based solely on overall organization-wide performance are unlikely to provide employees, other than senior executives and individuals who have the ability to materially affect the organization's overall risk profile, with unbalanced risk-taking incentives.

Incentive compensation arrangements should not only be balanced in design, they also should be implemented so that actual payments vary based on risks or risk outcomes. If, for example, employees are paid substantially all of their potential incentive compensation even when risk or risk outcomes are materially worse than expected, employees have less incentive to avoid activities with substantial risk.

- *Banking organizations should consider the full range of risks associated with an employee's activities, as well as the time horizon over which those risks may be realized, in assessing whether incentive compensation arrangements are balanced.*

The activities of employees may create a wide range of risks for a banking organization, such as credit, market, liquidity, operational, legal, compliance, and reputational risks, as well as other risks to the viability or operation of the organization. Some of these risks may be realized in the short term, while others may become apparent only over the long term. For example, future revenues that are booked as current income may not materialize, and short-term profit-and-loss measures may not appropriately reflect differences in the risks associated with the revenue derived from different activities (e.g., the higher credit or compliance risk associated with subprime loans versus prime loans).[12] In addition, some risks (or combinations of risky strategies and positions) may have a low probability of being realized, but would have highly adverse effects on the organization if they were to be realized ("bad tail risks"). While shareholders may have less incentive to guard against bad tail risks because of the infrequency of their realization and the existence of the federal safety net, these risks warrant special attention for safety-and-soundness reasons given the threat they pose to the organization's solvency and the federal safety net.

Banking organizations should consider the full range of current and potential risks associated with the activities of covered employees, including the cost and amount of capital and liquidity needed to support those risks, in developing balanced incentive compensation arrangements. Reliable quantitative measures of risk and risk outcomes ("quantitative measures"), where available, may be particularly useful in developing balanced compensation arrangements and in assessing the extent to which arrangements are properly balanced. However, reliable quantitative measures may not be available for all types of risk or for all activities, and their utility for use in compensation arrangements varies across business lines and employees. The absence of reliable quantitative measures for certain types of risks or outcomes does not mean that banking organizations should ignore such risks or outcomes for purposes of assessing whether an incentive compensation

12. Importantly, the time horizon over which a risk outcome may be realized is not necessarily the same as the stated maturity of an exposure. For example, the ongoing reinvestment of funds by a cash management unit in commercial paper with a one-day maturity not only exposes the organization to one-day credit risk, but also exposes the organization to liquidity risk that may be realized only infrequently.

arrangement achieves balance. For example, while reliable quantitative measures may not exist for many bad-tail risks, it is important that such risks be considered given their potential effect on safety and soundness. As in other risk-management areas, banking organizations should rely on informed judgments, supported by available data, to estimate risks and risk outcomes in the absence of reliable quantitative risk measures.

Large complex banking organizations. In designing and modifying incentive compensation arrangements, LCBOs should assess in advance of implementation whether such arrangements are likely to provide balanced risk-taking incentives. Simulation analysis of incentive compensation arrangements is one way of doing so. Such analysis uses forward-looking projections of incentive compensation awards and payments based on a range of performance levels, risk outcomes, and levels of risks taken. This type of analysis, or other analysis that results in assessments of likely effectiveness, can help an LCBO assess whether incentive compensation awards and payments to an employee are likely to be reduced appropriately as the risks to the organization from the employee's activities increase.

- *An unbalanced arrangement can be moved toward balance by adding or modifying features that cause the amounts ultimately received by employees to appropriately reflect risk and risk outcomes.*

If an incentive compensation arrangement may encourage employees to expose their banking organization to imprudent risks, the organization should modify the arrangement as needed to ensure that it is consistent with safety and soundness. Four methods are often used to make compensation more sensitive to risk. These methods are:

1. *Risk Adjustment of Awards:* The amount of an incentive compensation award for an employee is adjusted based on measures that take into account the risk the employee's activities may pose to the organization. Such measures may be quantitative, or the size of a risk adjustment may be set judgmentally, subject to appropriate oversight.
2. *Deferral of Payment:* The actual payout of an award to an employee is delayed significantly beyond the end of the performance period, and the amounts paid are adjusted for actual losses or other aspects of performance that are realized or become better known only during the deferral period.[13] Deferred payouts may be altered according to risk outcomes either formulaically or judgmentally, subject to appropriate oversight. To be most effective, the deferral period should be sufficiently long to allow for the realization of a substantial portion of the risks from employee activities, and the measures of loss should be clearly explained to employees and closely tied to their activities during the relevant performance period.
3. *Longer Performance Periods:* The time period covered by the performance measures used in determining an employee's award is extended (for example, from one year to two or more years). Longer performance periods and deferral of payment are related in that both methods allow awards or payments to be made after some or all risk outcomes are realized or better known.
4. *Reduced Sensitivity to Short-Term Performance:* The banking organization reduces the rate at which awards increase as an employee achieves higher levels of the relevant performance measure(s). Rather than offsetting risk-taking incentives associated with the use of short-term performance measures, this method reduces the magnitude of such incentives. This method also can include improving the quality and reliability of performance measures in taking into account both short-term and long-term risks, for example improving the reliability and accuracy of estimates of revenues and long-term profits upon which performance measures depend.[14]

13. The deferral-of-payment method is sometimes referred to in the industry as a "clawback." The term "clawback" also may refer specifically to an arrangement under which an employee must return incentive compensation payments previously received by the employee (and not just deferred) if certain risk outcomes occur. Section 304 of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7243), which applies to chief executive officers and chief financial officers of public banking organizations, is an example of this more specific type of "clawback" requirement.

14. Performance targets may have a material effect on risk-taking incentives. Such targets may offer employees greater rewards for increments of performance that are above

These methods for achieving balance are not exclusive, and additional methods or variations may exist or be developed. Moreover, each method has its own advantages and disadvantages. For example, where reliable risk measures exist, risk adjustment of awards may be more effective than deferral of payment in reducing incentives for imprudent risk-taking. This is because risk adjustment potentially can take account of the full range and time horizon of risks, rather than just those risk outcomes that occur or become more evident during the deferral period. On the other hand, deferral of payment may be more effective than risk adjustment in mitigating incentives to take hard-to-measure risks (such as the risks of new activities or products, or certain risks such as reputational or operational risk that may be difficult to measure with respect to particular activities), especially if such risks are likely to be realized during the deferral period. Accordingly, in some cases two or more methods may be needed in combination for an incentive compensation arrangement to be balanced.

The greater the potential incentives an arrangement creates for an employee to increase the risks associated with the employee's activities, the stronger the effect should be of the methods applied to achieve balance. Thus, for example, risk adjustments used to counteract a materially unbalanced compensation arrangement should have a similarly material impact on the incentive compensation paid under the arrangement. Further, improvements in the quality and reliability of performance measures themselves, for example, improving the reliability and accuracy of estimates of revenues and profits upon which performance measures depend, can significantly improve the degree of balance in risk-taking incentives.

Where judgment plays a significant role in the design or operation of an incentive compensation arrangement, strong policies and procedures, internal controls, and ex post monitoring of incentive compensation payments relative to actual risk outcomes are particularly important to help ensure that the arrangements as implemented are balanced and do not encourage imprudent risk-taking. For example, if a banking organization relies to a significant degree on the judgment of one or more managers to ensure that the incentive compensation awards to employees are appropriately risk-adjusted, the organization should have policies and procedures that describe how managers are expected to exercise that judgment to achieve balance and that provide for the manager(s) to receive appropriate available information about the employee's risk-taking activities to make informed judgments.

the target or may provide that awards will be granted only if a target is met or exceeded. Employees may be particularly motivated to take imprudent risk in order to reach performance targets that are aggressive but potentially achievable.

Large complex banking organizations. Methods and practices for making compensation sensitive to risk are likely to evolve rapidly during the next few years, driven in part by the efforts of supervisors and other stakeholders. LCBOs should actively monitor developments in the field and should incorporate into their incentive compensation systems new or emerging methods or practices that are likely to improve the organization's long-term financial well-being and safety and soundness.

- *The manner in which a banking organization seeks to achieve balanced incentive compensation arrangements should be tailored to account for the differences between employees—including the substantial differences between senior executives and other employees—as well as between banking organizations.*

Activities and risks may vary significantly both across banking organizations and across employees within a particular banking organization. For example, activities, risks, and incentive compensation practices may differ materially among banking organizations based on, among other things, the scope or complexity of activities conducted and the business strategies pursued by the organizations. These differences mean that methods for achieving balanced compensation arrangements at one organization may not be effective in restraining incentives to engage in imprudent risk-taking at another organization. Each organization is responsible for ensuring that its incentive compensation arrangements are consistent with the safety and soundness of the organization.

Moreover, the risks associated with the activities of one group of non-executive employees (e.g., loan originators) within a banking organization may differ significantly from those of another group of non-executive employees (e.g., spot foreign exchange traders) within the organization. In addition, reliable quantitative measures of risk and risk outcomes are unlikely to be available for a banking organization as a whole, particularly a large, complex organization. This factor can make it difficult for banking organizations to achieve balanced compensation arrangements for senior executives who have responsibility for managing risks on an organization-wide basis solely through use of the risk-adjustment-of-award method.

Furthermore, the payment of deferred incentive compensation in equity (such as restricted stock of the organization) or equity-based instruments (such as options to acquire the organization's stock) may be helpful in restraining the risk-taking incentives of senior executives and other covered employees whose activities may have a material effect on the overall financial performance of the organization. However, equity-related deferred compensation may not be as effective in restraining the incentives of lower-level covered employees (particularly at large organizations) to take risks because such employees are unlikely to believe that their actions will materially affect the organization's stock price.

Banking organizations should take account of these differences when constructing balanced compensation arrangements. For most banking organizations, the use of a single, formulaic approach to making employee incentive compensation arrangements appropriately risk-sensitive is likely to result in arrangements that are unbalanced at least with respect to some employees.[15]

Large complex banking organizations. Incentive compensation arrangements for senior executives at LCBOs are likely to be better balanced if they involve deferral of a substantial portion of the executives' incentive compensation over a multi-year period in a way that reduces the amount received in the event of poor performance, substantial use of multi-year performance periods, or both. Similarly, the compensation arrangements for senior executives at LCBOs are likely to be better balanced if a significant portion of the incentive compensation of these executives is paid in the form of equity-based instruments that vest over multiple years, with the number of instruments ultimately received dependent on the performance of the organization during the deferral period.

The portion of the incentive compensation of other covered employees that is deferred or paid in the form of equity-based instruments should appropriately take into account the level, nature, and duration of the risks that the employees' activities create for the organization and the extent to which those activities may materially affect the overall performance of the organization and its stock price. Deferral of a substantial portion of an employee's incentive compensation may not be workable for employees at lower pay scales because of their more limited financial resources. This may require increased reliance on other measures in the incentive compensation arrangements for these employees to achieve balance.

- *Banking organizations should carefully consider the potential for "golden parachutes" and the vesting arrangements for deferred compensation to affect the risk-taking behavior of employees while at the organizations.*

Arrangements that provide for an employee (typically a senior executive), upon departure from the organization or a change in control of the organization, to receive large additional payments or the accelerated payment of deferred amounts without regard to risk or risk outcomes can provide the employee significant incentives to expose the organization to undue risk. For example, an arrangement that provides an employee with a guaranteed payout upon departure from an organization, regardless of performance, may neutralize the effect of any balancing features included in the arrangement to help prevent imprudent risk-taking.

Banking organizations should carefully review any such existing or proposed arrangements (sometimes called "golden parachutes") and the potential impact of such arrangements on the organization's safety and soundness. In appropriate circumstances an organization should consider including balancing features—such as risk adjustment or deferral requirements that extend past the employee's departure—in the arrangements to mitigate the potential for the arrangements to encourage imprudent risk-taking. In all cases, a banking organization should ensure that the structure and terms of any golden parachute

15. For example, spreading payouts of incentive compensation awards over a standard three-year period may not appropriately reflect the differences in the type and time horizon of risk associated with the activities of different groups of employees, and may not be sufficient by itself to balance the compensation arrangements of employees who may expose the organization to substantial longer-term risks.

arrangement entered into by the organization do not encourage imprudent risk-taking in light of the other features of the employee's incentive compensation arrangements.

Large complex banking organizations. Provisions that require a departing employee to forfeit deferred incentive compensation payments may weaken the effectiveness of the deferral arrangement if the departing employee is able to negotiate a "golden handshake" arrangement with the new employer.[16] This weakening effect can be particularly significant for senior executives or other skilled employees at LCBOs whose services are in high demand within the market.

Golden handshake arrangements present special issues for LCBOs and supervisors. For example, while a banking organization could adjust its deferral arrangements so that departing employees will continue to receive any accrued deferred compensation after departure (subject to any clawback or malus[17]), these changes could (1) reduce the employee's incentive to remain at the organization and, thus, weaken an organization's ability to retain qualified talent, which is an important goal of compensation, and (2) create conflicts of interest. Moreover, actions of the hiring organization (which may or may not be a supervised banking organization) ultimately may defeat these or other risk-balancing aspects of a banking organization's deferral arrangements. LCBOs should monitor whether golden handshake arrangements are materially weakening the organization's efforts to constrain the risk-taking incentives of employees. The Federal Reserve will continue to work with banking organizations and others to develop appropriate methods for addressing any effect that such arrangements may have on the safety and soundness of banking organizations.

- *Banking organizations should effectively communicate to employees the ways in which incentive compensation awards and payments will be reduced as risks increase.*

In order for the risk-sensitive provisions of incentive compensation arrangements to affect employee risk-taking behavior, the organization's employees need to understand that the amount of incentive compensation that they may receive will vary based on the risk associated with their activities. Accordingly, banking organizations should ensure that employees covered by an incentive compensation arrangement are informed about the key ways in which risks are taken into account in determining the amount of incentive compensation paid. Where feasible, an organization's communications with employees should include examples of how incentive compensation payments may be adjusted to reflect projected or actual risk outcomes. An organization's communications should be tailored appropriately to reflect the sophistication of the relevant audience(s).

Principle 2: Compatibility with Effective Controls and Risk-Management

A banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

In order to increase their own compensation, employees may seek to evade the processes established by a banking organization to achieve balanced compensation arrangements. Similarly, an employee covered by an incentive compensation arrangement may seek to influence, in ways designed to increase the employee's pay, the risk measures or other information or judgments that are used to make the employee's pay sensitive to risk.

Such actions may significantly weaken the effectiveness of an organization's incentive compensation arrangements in restricting imprudent risk-taking. These actions can have a particularly damaging effect on the safety and soundness of the organization if they result in the weakening of risk measures, information, or judgments that the organization uses for other risk-management, internal control, or financial purposes. In such cases, the employee's actions

16. Golden handshakes are arrangements that compensate an employee for some or all of the estimated, non-adjusted value of deferred incentive compensation that would have been forfeited upon departure from the employee's previous employment.

17. A malus arrangement permits the employer to prevent vesting of all or part of the amount of a deferred remuneration award. Malus provisions are invoked when risk outcomes are worse than expected or when the information upon which the award was based turns out to have been incorrect. Loss of unvested compensation due to the employee voluntarily leaving the firm is not an example of malus as the term is used in this guidance.

may weaken not only the balance of the organization's incentive compensation arrangements, but also the risk-management, internal controls, and other functions that are supposed to act as a separate check on risk-taking. For this reason, traditional risk-management controls alone do not eliminate the need to identify employees who may expose the organization to material risk, nor do they obviate the need for the incentive compensation arrangements for these employees to be balanced. Rather, a banking organization's risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements.

- *Banking organizations should have appropriate controls to ensure that their processes for achieving balanced compensation arrangements are followed and to maintain the integrity of their risk-management and other functions.*

To help prevent damage from occurring, a banking organization should have strong controls governing its process for designing, implementing, and monitoring incentive compensation arrangements. Banking organizations should create and maintain sufficient documentation to permit an audit of the effectiveness of the organization's processes for establishing, modifying, and monitoring incentive compensation arrangements. Smaller banking organizations should incorporate reviews of these processes into their overall framework for compliance monitoring (including internal audit).

Large complex banking organizations. LCBOs should have and maintain policies and procedures that (1) identify and describe the role(s) of the personnel, business units, and control units authorized to be involved in the design, implementation, and monitoring of incentive compensation arrangements; (2) identify the source of significant risk-related inputs into these processes and establish appropriate controls governing the development and approval of these inputs to help ensure their integrity; and (3) identify the individual(s) and control unit(s) whose approval is necessary for the establishment of new incentive compensation arrangements or modification of existing arrangements.

An LCBO also should conduct regular internal reviews to ensure that its processes for achieving and maintaining balanced incentive compensation arrangements are consistently followed. Such reviews should be conducted by audit, compliance, or other personnel in a manner consistent with the organization's overall framework for compliance monitoring. An LCBO's internal audit department also should separately conduct regular audits of the organization's compliance with its established policies and controls relating to incentive compensation arrangements. The results should be reported to appropriate levels of management and, where appropriate, the organization's board of directors.

- *Appropriate personnel, including risk-management personnel, should have input into the organization's processes for designing incentive compensation arrangements and assessing their effectiveness in restraining imprudent risk-taking.*

Developing incentive compensation arrangements that provide balanced risk-taking incentives and monitoring arrangements to ensure they achieve balance over time requires an understanding of the risks (including compliance risks) and potential risk outcomes associated with the activities of the relevant employees. Accordingly, banking organizations should have policies and procedures that ensure that risk-management personnel have an appropriate role in the organization's processes for designing incentive compensation arrangements and for assessing their effectiveness in restraining imprudent risk-taking.[18] Ways that risk managers might assist in achieving balanced compensation arrangements include, but are not limited to

1. reviewing the types of risks associated with the activities of covered employees;
2. approving the risk measures used in risk adjustments and performance measures, as well as measures of risk outcomes used in deferred-payout arrangements; and
3. analyzing risk-taking and risk outcomes relative to incentive compensation payments.

Other functions within an organization, such as its control, human resources, or finance func-

18. Involvement of risk-management personnel in the design and monitoring of these arrangements also should help ensure that the organization's risk-management functions can properly understand and address the full range of risks facing the organization.

tions, also play an important role in helping ensure that incentive compensation arrangements are balanced. For example, these functions may contribute to the design and review of performance measures used in compensation arrangements or may supply data used as part of these measures.

- *Compensation for employees in risk-management and control functions should be sufficient to attract and retain qualified personnel and should avoid conflicts of interest.*

The risk-management and control personnel involved in the design, oversight, and operation of incentive compensation arrangements should have appropriate skills and experience needed to effectively fulfill their roles. These skills and experiences should be sufficient to equip the personnel to remain effective in the face of challenges by covered employees seeking to increase their incentive compensation in ways that are inconsistent with sound risk-management or internal controls. The compensation arrangements for employees in risk-management and control functions thus should be sufficient to attract and retain qualified personnel with experience and expertise in these fields that is appropriate in light of the size, activities, and complexity of the organization.

In addition, to help preserve the independence of their perspectives, the incentive compensation received by risk-management and control personnel staff should not be based substantially on the financial performance of the business units that they review. Rather, the performance measures used in the incentive compensation arrangements for these personnel should be based primarily on the achievement of the objectives of their functions (e.g., adherence to internal controls).

- *Banking organizations should monitor the performance of their incentive compensation arrangements and should revise the arrangements as needed if payments do not appropriately reflect risk.*

Banking organizations should monitor incentive compensation awards and payments, risks taken, and actual risk outcomes to determine whether incentive compensation payments to employees are reduced to reflect adverse risk outcomes or high levels of risk taken. Results should be reported to appropriate levels of management, including the board of directors where warranted and consistent with Principle 3 below. The monitoring methods and processes used by a banking organization should be commensurate with the size and complexity of the organization, as well as its use of incentive compensation. Thus, for example, a small, noncomplex organization that uses incentive compensation only to a limited extent may find that it can appropriately monitor its arrangements through normal management processes.

A banking organization should take the results of such monitoring into account in establishing or modifying incentive compensation arrangements and in overseeing associated controls. If, over time, incentive compensation paid by a banking organization does not appropriately reflect risk outcomes, the organization should review and revise its incentive compensation arrangements and related controls to ensure that the arrangements, as designed and implemented, are balanced and do not provide employees incentives to take imprudent risks.

Principle 3: Strong Corporate Governance

Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

Given the key role of senior executives in managing the overall risk-taking activities of an organization, the board of directors of a banking organization should directly approve the incentive compensation arrangements for senior executives.[19] The board also should approve and document any material exceptions or adjustments to the incentive compensation arrangements established for senior executives and

19. As used in this guidance, the term "board of directors" is used to refer to the members of the board of directors who have primary responsibility for overseeing the incentive compensation system. Depending on the manner in which the board is organized, the term may refer to the entire board of directors, a compensation committee of the board, or another committee of the board that has primary responsibility for overseeing the incentive compensation system. In the case of FBOs, the term refers to the relevant oversight body for the firm's U.S. operations, consistent with the FBO's overall corporate and management structure.

should carefully consider and monitor the effects of any approved exceptions or adjustments on the balance of the arrangement, the risk-taking incentives of the senior executive, and the safety and soundness of the organization.

The board of directors of an organization also is ultimately responsible for ensuring that the organization's incentive compensation arrangements for all covered employees are appropriately balanced and do not jeopardize the safety and soundness of the organization. The involvement of the board of directors in oversight of the organization's overall incentive compensation program should be scaled appropriately to the scope and prevalence of the organization's incentive compensation arrangements.

Large complex banking organizations and organizations that are significant users of incentive compensation. The board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should actively oversee the development and operation of the organization's incentive compensation policies, systems, and related control processes. The board of directors of such an organization should review and approve the overall goals and purposes of the organization's incentive compensation system. In addition, the board should provide clear direction to management to ensure that the goals and policies it establishes are carried out in a manner that achieves balance and is consistent with safety and soundness.

The board of directors of such an organization also should ensure that steps are taken so that the incentive compensation system—including performance measures and targets—is designed and operated in a manner that will achieve balance.

- *The board of directors should monitor the performance, and regularly review the design and function, of incentive compensation arrangements.*

To allow for informed reviews, the board should receive data and analysis from management or other sources that are sufficient to allow the board to assess whether the overall design and performance of the organization's incentive compensation arrangements are consistent with the organization's safety and soundness. These reviews and reports should be appropriately scoped to reflect the size and complexity of the banking organization's activities and the prevalence and scope of its incentive compensation arrangements.

The board of directors of a banking organization should closely monitor incentive compensation payments to senior executives and the sensitivity of those payments to risk outcomes. In addition, if the compensation arrangement for a senior executive includes a clawback provision, then the review should include sufficient information to determine if the provision has been triggered and executed as planned.

The board of directors of a banking organization should seek to stay abreast of significant emerging changes in compensation plan mechanisms and incentives in the marketplace as well as developments in academic research and regulatory advice regarding incentive compensation policies. However, the board should recognize that organizations, activities, and practices within the industry are not identical. Incentive compensation arrangements at one organization may not be suitable for use at another organization because of differences in the risks, controls, structure, and management among organizations. The board of directors of each organization is responsible for ensuring that the incentive compensation arrangements for its organization do not encourage employees to take risks that are beyond the organization's ability to manage effectively, regardless of the practices employed by other organizations.

Large complex banking organizations and organizations that are significant users of incentive compensation. The board of an LCBO or other organization that uses incentive compensation to a significant extent should receive and review, on an annual or more frequent basis, an assessment by management, with appropriate input from risk-management personnel, of the effectiveness of the design and operation of the organization's incentive compensation system in providing risk-taking incentives that are consistent with the organization's safety and soundness. These reports should include an evaluation of whether or how incentive compensation practices may increase the potential for imprudent risk-taking.

The board of such an organization also should receive periodic reports that review incentive compensation awards and payments relative to risk outcomes on a backward-looking basis to determine whether the organization's incentive compensation arrangements may be promoting imprudent risk-taking. Boards of directors of these organizations also should consider periodically obtaining and reviewing simulation analysis of compensation on a forward-looking basis based on a range of performance levels, risk outcomes, and the amount of risks taken.

- *The organization, composition, and resources of the board of directors should permit effective oversight of incentive compensation.*

The board of directors of a banking organization should have, or have access to, a level of expertise and experience in risk-management and compensation practices in the financial services industry that is appropriate for the nature, scope, and complexity of the organization's activities. This level of expertise may be present collectively among the members of the board, may come from formal training or from experience in addressing these issues, including as a director, or may be obtained through advice received from outside counsel, consultants, or other experts with expertise in incentive compensation and risk-management. The board of directors of an organization with less complex and extensive incentive compensation arrangements may not find it necessary or appropriate to require special board expertise or to retain and use outside experts in this area.

In selecting and using outside parties, the board of directors should give due attention to potential conflicts of interest arising from other dealings of the parties with the organization or for other reasons. The board also should exercise caution to avoid allowing outside parties to obtain undue levels of influence. While the retention and use of outside parties may be helpful, the board retains ultimate responsibility for ensuring that the organization's incentive compensation arrangements are consistent with safety and soundness.

Large complex banking organizations and organizations that are significant users of incentive compensation. If a separate compensation committee is not already in place or required by other authorities,[20] the board of directors of an LCBO or other banking organization that uses incentive compensation to a significant extent should consider establishing such a committee—reporting to the full board—that has primary responsibility for overseeing the organization's incentive compensation systems. A compensation committee should be composed solely or predominantly of non-executive directors. If the board does not have such a compensation committee, the board should take other steps to ensure that non-executive directors of the board are actively involved in the oversight of incentive compensation systems. The compensation committee should work closely with any board-level risk and audit committees where the substance of their actions overlap.

- *A banking organization's disclosure practices should support safe and sound incentive compensation arrangements.*

If a banking organization's incentive compensation arrangements provide employees incentives to take risks that are beyond the tolerance of the organization's shareholders, these risks are likely to also present a risk to the safety and soundness of the organization.[21] To help promote safety and soundness, a banking organization should provide an appropriate amount of information concerning its incentive compensation arrangements for executive and non-executive employees and related risk-management, control, and governance processes to shareholders to allow them to monitor and, where appropriate, take actions to restrain the potential for such arrangements and processes that encourage employees to take imprudent risks. Such disclosures should include information relevant to employees other than senior executives. The scope and level of the information disclosed by the organization should be tailored to the nature and complexity of the organization and its incentive compensation arrangements.[22]

- *Large complex banking organizations should follow a systematic approach to developing a compensation system that has balanced incentive compensation arrangements.*

20. See New York Stock Exchange Listed Company Manual Section 303A.05(a); Nasdaq Listing Rule 5605(d); Internal Revenue Code section 162(m) (26 U.S.C. 162(m)).

21. On the other hand, as noted previously, compensation arrangements that are in the interests of the shareholders of a banking organization are not necessarily consistent with safety and soundness.

22. A banking organization also should comply with the incentive compensation disclosure requirements of the federal securities law and other laws as applicable. See, for example, Proxy Disclosure Enhancements, SEC Release Nos. 33-9089, 34-61175, 74 F.R. 68334 (Dec. 23, 2009) (to be codified at 17 CFR 229 and 249).

At banking organizations with large numbers of risk-taking employees engaged in diverse activities, an ad hoc approach to developing balanced arrangements is unlikely to be reliable. Thus, an LCBO should use a systematic approach—supported by robust and formalized policies, procedures, and systems—to ensure that those arrangements are appropriately balanced and consistent with safety and soundness. Such an approach should provide for the organization effectively to:

1. Identify employees who are eligible to receive incentive compensation and whose activities may expose the organization to material risks. These employees should include
   a. senior executives and others who are responsible for oversight of the organization's firm-wide activities or material business lines;
   b. individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and
   c. groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk;
2. Identify the types and time horizons of risks to the organization from the activities of these employees;
3. Assess the potential for the performance measures included in the incentive compensation arrangements for these employees, those that encourage employees to take imprudent risks;
4. Include balancing elements (such as risk adjustments or deferral periods) within the incentive compensation arrangements for these employees, that are reasonably designed to ensure that the arrangement will be balanced in light of the size, type, and time horizon of the inherent risks of the employees' activities;
5. Communicate to the employees the ways in which their incentive compensation awards or payments will be adjusted to reflect the risks of their activities to the organization; and
6. Monitor incentive compensation awards, payments, risks taken, and risk outcomes for these employees and modify the relevant arrangements if payments made are not appropriately sensitive to risk and risk outcomes.

CONCLUSION ON SOUND INCENTIVE COMPENSATION

Banking organizations are responsible for ensuring that their incentive compensation arrangements do not encourage imprudent risk-taking behavior and are consistent with the safety and soundness of the organization. The Federal Reserve expects banking organizations to take prompt action to address deficiencies in their incentive compensation arrangements or related risk-management, control, and governance processes.

The Federal Reserve intends to actively monitor the actions taken by banking organizations in this area and will promote further advances in designing and implementing balanced incentive compensation arrangements. Where appropriate, the Federal Reserve will take supervisory or enforcement action to ensure that material deficiencies that pose a threat to the safety and soundness of the organization are promptly addressed. The Federal Reserve also will update this guidance as appropriate to incorporate best practices as they develop over time.

The purpose of this section is to guide the examiner in evaluating bank management. Although the directorate is an integral part of the overall management of a bank, the management appraisal examination program is concerned primarily with the active officers. A review of the quality of director guidance and supervision is covered in "Duties and Responsibilities of Directors."

It is the responsibility of directors to employ a competent chief executive officer. Thereafter, senior management normally assumes the responsibility to employ, maintain and educate a qualified staff. Since a direct relationship exists between the overall condition of a bank and the quality of management, the first priority in evaluating the condition of the bank is to make an accurate appraisal of the competency of the management team.

Management is responsible, not only for the operations of the bank and the quality of its assets on a day-to-day basis, but also for planning for the future. Senior management should be evaluated on its plans for maintaining or improving the condition of the bank in the future as well as on the bank's present condition. The depth of planning and a general forward looking attitude of executive officers should be considered when projecting future management impact. This should include an evaluation of management's efforts to provide for succession of senior bank officials.

The projection of future management impact involves an appraisal of the quality and quantity of senior and middle management. This assessment of course must be relative to the size and community circumstances of the bank. Examiners must not restrict their appraisals to the past and present. The past and present certainly are significant, requiring an in-depth analysis of financial condition, earnings and capital adequacy, both on an absolute basis and as a trend, but, the determination of what the management will do for the bank in the future is most significant. The System's goal is to prevent problems from developing rather than waiting for future examinations to identify deteriorating conditions.

Bank management receives strong pressure from customers, stockholders and competitors. Customers demand more for their money, in the form of both interest and services, and stockholders demand higher returns on their investments, both in dividends and increased market value of their stock. No bank is completely free from the pressure of competition and, for most institutions, this is one of the strongest forces felt. In the midst of those pressures, the clear mandate to bank management is to "perform." Performance is measured in terms of long-run profitability, liquidity and solvency. It is almost impossible for a bank to achieve those long-range goals unless careful planning and coordination bring efficiency to its activities. Management must recognize the bank's position in the market and make plans which will achieve the objectives set for the institution by the directors. It must be constantly alert to the need for continually upgrading and expanding services and facilities to support and encourage the bank's growth.

Both the directors and senior management have important roles in a bank's program of internal control and internal audit. Although directors have overall audit responsibility and should require that the auditor report directly to them, senior management normally is charged with the duty of maintaining a strong system of internal control.

The entire examination procedure, as outlined throughout this manual, is designed to provide a clear picture of both the present and anticipated future condition of the bank under examination. As a result, the reports and workpapers generated by the examination process will serve as a major tool for examiners in their evaluation of management. Examination procedures for various balance sheet accounts and departmental areas are designed to effect a comprehensive evaluation of internal control and internal and/or external audit, and will provide the examiner with insight into the degree of compliance with the bank's own written policies in such areas. Similarly, the examination procedures in "Loan Portfolio Management," "Investment Securities," "Funds Management," "Assessment of Capital Adequacy," and "Analytical Review and Income and Expense" are designed to lead to a detailed analysis of written objectives, policies and procedures in those management areas.

The examiner must take a practical approach to evaluating these features depending on the bank's characteristics. The examiner can have greater confidence in the continuity of top and middle management when it is known that the bank has an inflow of new personnel at various levels and that training procedures and advancement policies will keep the organization viable and dynamic.

The examiner must be concerned with salary levels within the bank and must review information collected during the examination about the bank's employee benefits program. Salaries paid and benefits provided should be compared with those offered by an appropriate peer group, and inquiry should be made to determine the relationship between the bank's payroll structure and that offered by competitors for the same caliber personnel.

The examiner must judge the appropriateness of asset distribution in view of the bank's sources of funds. The examiner must evaluate the adequacy of the bank's capital position and expectations in view of asset quality and plans for growth and expansion. The overall management evaluation should be made by the examiner-in-charge, because he or she is in the best position to identify weaknesses and inconsistencies in policies. Although examiners-in-charge will rely heavily upon the information received from assisting examining personnel in various areas under review, it is their task to assemble all of such information into a composite picture of the quality of management.

Senior management is responsible for the quality of all bank personnel and for planning its own replacement. A bank's recruiting, training, and personnel development activities are vital to the development and continuity of a quality staff. The examiner must evaluate those areas to determine the quality of overall management. Some features of good personnel management are:

- An organizational structure.
- Detailed position descriptions.
- Carefully planned recruiting.
- Appropriate training.
- Performance review.
- Salary administration.
- Provision for communication.

The examiner should identify and interpret trends that can reveal flaws in policy either as written or as practiced. The examiner should question the quality of management in any area in which he or she finds serious shortcomings or makes significant criticisms.

The examiner should be alert for situations in which top management dominates the board or where top management acts solely at the direction of either the board or a dominant influence on the board. Although it is extremely important for the directors to assume their appropriate role in setting objectives and formulating policy consistent with their responsibilities to the depositors, shareholders and regulators, dialogue with top management must occur. In banks where both directors and senior management recognize and assume their appropriate duties and responsibilities, areas for conflict are greatly reduced.

1. To determine the consistency of written objectives, policies, and procedures in the various asset, liability, and operational areas.
2. To determine that policies are being adhered to throughout the system.
3. To determine that management plans adequately for future conditions and developments.
4. To evaluate the adequacy of the bank's personnel practices as they relate to management continuity.
5. To evaluate management experience and depth.
6. To determine that management has established systems which facilitate efficient operation and communication.
7. To evaluate the propriety and soundness of management decisions.
8. To project the impact of management on the future condition of the bank.

In the following procedural steps examiners should attempt to utilize already developed material from internal or external audit sources. Also, the examining resources and circumstances of the bank must be weighed in perspective to set the depth of scope for this area.

1. Obtain the following, if available:
   a. Organization chart.
   b. Management plan.
   c. Administrative and personal manuals.
   d. Marketing plan.
   e. Resumes for all executive officers and department or division heads which have not been obtained in previous examinations.
   f. A list of the salary of and other compensation paid to each executive officer.
   g. A list of the salary ranges for other officers of the bank broken down by position.
   h. A description of other employee benefits.
2. Become familiar with the quality of key personnel by:
   a. Updating management briefs for all executive officers and department or division heads.
   b. Distributing the updated management briefs to appropriate examining personnel and requesting that they be returned upon completion.
3. Review administrative manuals and:
   a. Extract any policy statements contained therein.
   b. Extract any general information considered relevant in appraising management.
   c. Analyze the manual(s), in general, as useful management tools.
4. Review management plan and extract information concerning:
   a. Areas of bank where increased or decreased officer staffing is planned.
   b. Number of officers to be added or removed.
   c. Qualification requirements for planned additional officers.
5. Establish the hierarchy of the organization by determining the functional responsibility levels of various officers and whether lines of authority are drawn in accordance with the organization chart.
6. Review the bank's marketing plan for specific programs being planned and general applicability to the institution.
7. Review the bank's schedule of salaries and make comparisons with similar information from an appropriate peer group. If deemed appropriate, compare salaries paid and benefits received in the bank to those of other institutions with which it competes directly. Determine whether the bank is paying salaries or bonuses to inactive officers or directors and, if so, determine that such payments have been disclosed to shareholders.
8. Determine whether any executive incentive compensation plans (performance bonuses) have been established and, if so;
   a. Review specific provisions of the plans and determine the beneficiaries.
   b. Review controls established to prevent the beneficiary(s) of the plan from understating noncash expenses (accrual expense accounts, provision for possible loan losses, etc.) or overstating noncash income (accrual income accounts).
9. Review the bank's activities with regard to developing personnel for senior management succession. At a minimum, this review should include:
   a. An assessment of the quality of lower levels of management and the potential for advancement.
   b. An assessment of the bank's officer hiring policies to determine that it is appropriate to meet the bank's current and future needs.
10. Obtain and analyze daily or other periodic reports submitted to executive management with the view of determining the usefulness of the reports in monitoring the condition and operation of the bank.
11. As the evaluation of the various areas of examination interest are being completed, discuss with assisting personnel:
    a. Any of their observations indicative of the general morale level.
    b. The technical proficiency of officers in their area.
    c. The level of direct impact that officers have on the condition of their areas.

12. Review the section on "Analytical Review and Income and Expense" and extract any information related to financial planning that is considered relevant to evaluating management. Also consider the quality, depth and applicability of financial planning.
13. In conjunction with reviewing the work papers and comments generated during the examination:
    a. Familiarize yourself with the bank's written objectives and policies.
    b. Analyze those policies and determine any inconsistencies in management areas.
    c. Review any internal control and policy exceptions and any other criticisms made in connection with the examination of all areas of the bank.
    d. Determine the extent to which improper implementation is negating the effect of written policies and procedures.
    e. Review the appropriateness of asset distribution in view of the bank's sources of funds.
    f. Review the evaluation of the bank's capital position and expectations in view of asset quality and plans for growth and expansion.
14. In cases where previously obtained information is incomplete or where no records could be reviewed, interview appropriate management in order to judge quality and depth. The interview should be conducted in such a manner as to generate necessary information for determining:
    a. Sources of information used to keep current.
    b. Stengths and weaknesses of lower level personnel.
    c. Succession of management and replacement of key personnel.
    d. General management plan.
    e. Methods of control utilized.
    f. Workload factors and efficiency of personnel.
    g. Frequency of staff meetings and how the communications system works.
    h. Management projections for the institution over the next year.
    i. Any major new proposal being considered or changes in asset mix or services.
    j. The nature and degree of working relationship with directors.
    k. The existence of any time-consuming outside activities of executive management.
15. By reviewing the results of the preceding steps and performing any other procedures deemed appropriate, answer the following questions (normally these questions will serve as a summary of information obtained, thus compiling factual data to support your objective comments on management):
    a. Have overall management objectives been set?
    b. Does the bank forecast manpower requirements?
    c. Are qualified people advanced from within?
    d. Are supervisory personnel involved in the selection of new employees and given the right of acceptance or rejection?
    e. Is management training given to those persons likely to assume higher level positions?
    f. Are salaries competitive?
    g. Are employee benefit programs competitive?
16. Prepare comments on the quality of management supervision. The comments should, at a minimum, discuss the following:
    a. General and technical ability.
    b. Effectiveness.
    c. Experience.
    d. Any inconsistencies in written objectives, policies and procedures.
    e. Any serious or widespread lack of proper implementation of written procedures.
    f. An evaluation of the bank's salary structure.
    g. The promptness with which management addresses problems.
    h. The extent to which executive management delegates and demands accountability.
    i. Any evidence that executive management is more concerned with the operation of a functional area than with overall supervision of the bank.
    j. The potential for upward movement of existing management personnel.
    k. Management's commitment to effecting corrective action in problem areas.
    l. Unsafe or unsound management.
    m. Any situation which might require close monitoring or removal of management.

17. For banks that are subsidiaries of bank holding companies (BHCs), review the relative degree of centralized control by parent or the lead bank, and evaluate:
    a. The general level of management's dependence on central BHC staff.
    b. Independence on final credit decisions.
    c. Independence on investment decisions.
    d. Independence on operational practices or service fee arrangements.

    While examiners may expect that economies of scale or optimization of tax, investment, or credit considerations on a consolidated basis may be beneficial to the entire organization, examiners must be alert to the danger of such considerations becoming overly burdensome or unfair to the subsidiary bank being examined. (Reference Federal Reserve Policy Statement on Intercorporate Income Tax Accounting Transactions of Bank Holding Companies and State Member Banks.)

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

1. Does the bank have an organizational chart?
2. If not, have lines of authority and reporting responsibility been formally established?
3. Does the bank have a full-time personnel manager?
4. Does the bank utilize written personnel manuals?
5. Does the bank utilize a system of written job descriptions, including descriptions for supervisory personnel?
6. Does the bank actively recruit personnel?
7. Does the bank perform background investigations of new employees?
8. Does the bank have a formal training program?
9. Does the bank utilize other than on-the-job training?
10. Does the bank utilize a graded salary scale?
11. Does the bank consider competition in preparing a salary range? If so, in what manner?
12. Does the top management at least annually review lower management?
13. Does the bank prepare or utilize a long-range forecast of economic conditions germane to its trade area?
14. Does top management consult with directors for their opinion of future condition?
15. Does the bank either employ an economist or utilize the services of an outside economic advisor?
16. Does senior management propose to the directors areas for policy decision?
17. Does the bank have a management succession plan?
18. Does the bank employ a marketing manager and/or outside marketing consultant?
19. Does senior management receive:
    a. A brief statement of condition daily?
    b. A daily liquidity report?
    c. A listing of assets subject to quality limitations at least monthly?
    d. An earnings statement on a comparative basis at least monthly?
20. Does the bank's auditing function audit the officer's adherence to general policy?
21. Are staff meetings held on a regular basis?
22. Are minutes kept for staff meetings?
23. Does the bank use a system of progress reports on specific projects?
24. Does the bank have a tax department or a tax consultant?

Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion

Effective date October 2023

Section 4011.1

INTRODUCTION AND APPLICABILITY

This section conveys the supervisory guidance that is attached to SR-16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than $100 Billion." The guidance in SR-16-11 applies to the supervision of Federal Reserve regulated institutions with total consolidated assets less than $100 billion, which includes state member banks, bank holding companies, savings and loan holding companies (including insurance and commercial savings and loan holding companies), as well as foreign banking organizations (FBOs) with consolidated U.S. assets of less than $100 billion. This guidance is not applicable to intermediate holding companies of foreign banking organizations established pursuant to the Federal Reserve's Regulation YY with total consolidated assets of $50 billion or more.

OVERVIEW

Managing risks is fundamental to the business of banking. Accordingly, the Federal Reserve places significant supervisory emphasis on an institution's management of risk, including its system of internal controls, when evaluating the overall effectiveness of an institution's risk management. An institution's failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks of its activities has long been considered unsafe and unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing an institution including, but not limited to, credit, market, liquidity, operational, compliance, and legal risk:

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, including, but not limited to, interest rates, foreign exchange rates, commodity prices, or equity prices.
- *Liquidity risk* is the potential that a financial institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk") or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market liquidity risk").
- *Operational risk* is the risk resulting from inadequate or failed internal processes, people, and systems or from external events (this definition conforms to the Basel committee's definition of operational risk).
- *Compliance risk* is the risk of regulatory sanctions, fines, penalties or losses resulting from failure to comply with laws, rules, regulations, or other supervisory requirements applicable to a financial institution.
- *Legal risk* is the potential that actions against the institution that result in unenforceable contracts, lawsuits, legal sanctions, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.

These risks and the activities associated with them are addressed in greater detail in the Federal Reserve's supervision manuals and other guidance documents.[1] In practice, an institution's business activities present various combinations, concentrations, and interrelationships of these risks depending on the nature and scope of the particular activity. This section provides guidelines for supervisory assessment of the overall effectiveness of an institution's risk management and its formal or informal systems for identifying, measuring, monitoring, and controlling these risks.

1. Refer to the Federal Reserve's *Commercial Bank Examination Manual*, *Bank Holding Company Supervision Manual*, *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations,* and relevant Federal Financial Institutions Examination Council Examination Manuals.

ELEMENTS OF RISK MANAGEMENT

As part of the risk management evaluation of overall management effectiveness at an institution, examiners should place primary consideration on findings relating to the following elements of a sound risk management system:

- board and senior management oversight[2]
- policies, procedures, and limits
- risk monitoring and management information systems
- internal controls

Each of these elements is described further, along with a list of considerations relevant to assessing each element. Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk management practices and are not a checklist of requirements for each institution.

An institution's risk management processes are expected to evolve in sophistication, commensurate with the institution's asset growth, complexity, and risk. At a larger or more complex organization, the institution should have more sophisticated risk management processes that address the full range of risks regardless of where the activity is conducted in the organization. Moreover, while a holding company should be able to assess the major risks of the consolidated organization, examiners should expect a parent company that centrally manages the operations and functions of its subsidiary banks to have more comprehensive, detailed, and developed risk management systems than a parent company that delegates the management of risks to relatively autonomous subsidiaries.[3]

For a small community banking organization (CBO) engaged solely in traditional banking activities and whose senior management is actively involved in the details of day-to-day operations, relatively basic risk management systems may be adequate. In accordance with the *Interagency Guidelines Establishing Standards for Safety and Soundness*, a CBO is expected, at a minimum, to have internal controls, information systems, and internal audit that are appropriate for the size of the institution and the nature, scope, and risk of its activities.[4]

The risk management processes of a regional banking organization (RBO) would typically contain detailed guidelines that set specific prudent limits on the principal types of risks relevant to a RBO's consolidated activities. Furthermore, because of the diversity and the geographic dispersion of their activities, these institutions will require relatively more sophisticated information systems that provide management with timely information that supports the management of risks. The information systems, in turn, should provide management with information that present a consolidated and integrated view of risks that are relevant to the duties and responsibilities of individual managers, senior management, and the board of directors.[5]

Consistent with the principle of national treatment, the Federal Reserve has the same supervisory goals and standards for the U.S. operations of FBOs as for domestic organizations of similar size, scope, and complexity.[6] Given the added element of foreign ownership, an FBO's risk management processes and control functions for the U.S. operations may be implemented domestically or outside of the United States. In cases where these functions are performed outside of the United States, the FBO's oversight function, policies and procedures, and information systems need to be sufficiently transparent to allow U.S. supervisors to assess their adequacy. Additionally, the FBO's U.S. senior management need to demonstrate and maintain a thorough understanding of all relevant risks affecting the U.S. operations and the associated

2. For the purpose of this guidance, for foreign banking organizations, "board of directors" refers to the equivalent governing body of the U.S. operations of the FBO.

3. If these subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely on the conclusions drawn by relevant regulators regarding risk management to the fullest extent possible. See also, SR-16-4, "Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion."

4. Refer to 12 CFR 208, Appendix D-1, the Interagency Guidelines Establishing Standards for Safety and Soundness.

5. Subpart C of the Federal Reserve's Regulation YY includes risk committee requirements for bank holding companies with total consolidated assets of $50 billion or more and less than $100 billion.

6. National treatment requires nondiscrimination between domestic and foreign firms, or treatment of foreign entities that is no less favorable than that accorded to domestic enterprises in like circumstances. The International Banking Act of 1978 generally gives foreign banks operating in the United States the same powers as domestic banking organizations and subjects them to the same restrictions and obligations.

management information systems, used to manage and monitor these risks within the U.S. operations.

The information systems at a larger institution will naturally require frequent monitoring and testing by independent control areas, and by both internal and external auditors, to ensure the integrity of the information used by the board of directors and senior management in overseeing compliance with policies and limits. Therefore, an institution's risk oversight function needs to be sufficiently independent of the business lines to achieve an adequate separation of duties and the avoidance of conflicts of interest.

Board and Senior Management Oversight

The board of directors has the responsibility for establishing the level of risk that the institution should take. Accordingly, the board of directors should approve the institution's overall business strategies and significant policies, including those related to managing risks. Further, the board of directors should also ensure that senior management is fully capable of implementing the institution's business strategies and risk limits. In evaluating senior management, the board of directors should consider whether management is taking the steps necessary to identify, measure, monitor, and control these risks.

The board of directors should collectively have a balance of skills, knowledge, and experience to clearly understand the activities and risks to which the institution is exposed. The board of directors should take steps to develop an appropriate understanding of the risks the institution faces, through briefings from experts internal to their organization and potentially from external experts. The institution's management information systems should provide the board of directors with sufficient information to identify the size and significance of the risks. Using this knowledge and information, the board of directors should provide clear guidance regarding the level of exposures acceptable to the institution and oversee senior management's implementation of the procedures and controls necessary to comply with approved policies.

Senior management is responsible for implementing strategies set by the board of directors in a manner that controls risks and that complies with laws, rules, regulations, or other supervisory requirements on both a long-term and day-to-day basis. Accordingly, senior management should be fully involved in and possess sufficient knowledge of all activities to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Senior management is also responsible for establishing and communicating a strong awareness of the need for effective risk management, internal controls, and high ethical business practices. To fulfill these responsibilities, senior management needs to have a thorough understanding of banking and financial market activities and detailed knowledge of the institution's activities, including the internal controls that are necessary to limit the related risks.

In assessing the quality of the oversight provided by the board of directors and senior management, examiners should consider the following:

- The board of directors has approved significant policies to establish risk tolerances for the institution's activities and periodically reviews risk exposure limits to align with changes in the institution's strategies, address new activities and products, and react to changes in the industry and market conditions.
- Senior management has identified and has a clear understanding and working knowledge of the risks inherent in the institution's activities. Senior management also remains informed about these risks as the institution's business activities evolve or expand and as changes and innovations occur in financial markets and risk management practices.
- Senior management has identified and reviewed risks associated with engaging in new activities or introducing new products to ensure that the necessary infrastructure and internal controls are in place to manage the related risks.
- Senior management has ensured that the institution's activities are managed and staffed by personnel with the knowledge, experience, and expertise consistent with the nature and scope of the institution's activities and risks.
- All levels of senior management provide appropriate management of the day-to-day activities of officers and employees, including oversight of senior officers or heads of business lines.
- Senior management has established and maintains effective information systems to identify, measure, monitor, and control the sources of risks to the institution.

Policies, Procedures, and Limits

Although an institution's board of directors approves an institution's overall business strategy and policy framework, senior management develops and implements the institution's risk management policies and procedures that address the types of risks arising from its activities. Once the risks are properly identified, the institution's policies and procedures should provide guidance for the day-to-day implementation of business strategies, including limits designed to prevent excessive and imprudent risks. An institution should have policies and procedures that address its significant activities and risks with the appropriate level of detail to address the type and complexity of the institution's operations. A smaller, less complex institution that has effective senior management directly involved in day-to-day operations would generally not be expected to have policies as sophisticated as larger institutions. In a larger institution, where senior managers rely on widely dispersed staffs to implement strategies for more varied and complex businesses, far more detailed policies and procedures would generally be expected. In either case, senior management is expected to ensure that policies and procedures address the institution's material areas of risk and that policies and procedures are modified when necessary to respond to significant changes in the institution's activities or business conditions.

The following guidelines should assist examiners in evaluating an institution's policies, procedures, and limits:

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its significant risk-taking activities.
- The policies, procedures, and limits are consistent with the institution's stated strategy and risk profile.
- The policies and procedures establish accountability and lines of authority across the institution's activities.
- The policies and procedures provide for the review and approval of new business lines, products, and activities, as well as material modifications to existing activities, services, and products, to ensure that the institution has the infrastructure necessary to identify, measure, monitor, and control associated risks before engaging in a new or modified business line, product, or activity.

Risk Monitoring and Management Information Systems

Institutions of all sizes are expected to have risk monitoring and management information systems in place that provide the board of directors and senior management with timely information and a clear understanding of the institution's business activities and risk exposures. The sophistication of risk monitoring and management information systems should be commensurate with the complexity and diversity of the institution's operations. Accordingly, a smaller and less complex institution may require less frequent management and board reports to support risk monitoring activities. For example, these reports may include, daily or weekly balance sheets and income statements, a watch list for potentially troubled loans, a report on past due loans, an interest rate risk report, and similar items. In contrast, a larger, more complex institution would be expected to have much more comprehensive reporting and monitoring systems, which includes more frequent reporting to board and senior management, tighter monitoring of high-risk activities, and the ability to aggregate risks on a fully consolidated basis across all business lines, legal entities, and activities.

In assessing an institution's measurement and monitoring of risk and its management reports and information systems, examiners should consider whether these conditions exist:

- The institution's risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, models, and procedures used in measuring and monitoring risks are appropriate and adequately documented and tested for reliability on an on-going basis.[7]
- Reports and other forms of communication address the complexity and range of an institution's activities, monitor key exposures and compliance with established limits and strategy, and as appropriate, compare actual versus expected performance.
- Reports to the board of directors and senior management are accurate, and provide timely and sufficient information to identify any adverse trends and to evaluate the level of risks faced by the institution.

7. See this manual's section "Model Risk Management," and SR-11-7, "Guidance on Model Risk Management."

Internal Controls

An effective internal control structure is critical to the safe and sound operation of an institution. Effective internal controls promote reliable financial and regulatory reporting, safeguard assets, and help to ensure compliance with relevant laws, rules, regulations, supervisory requirements, and institutional policies. Therefore, an institution's senior management is responsible for establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate segregation of duties.

Adequate segregation of duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate segregation of duties can constitute an unsafe and unsound practice and possibly lead to serious losses or otherwise compromise the integrity of the institution's internal controls. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

Internal controls should be tested by an independent party who reports either directly to the institution's board of directors or its designated committee, which is typically the audit committee.[8] However, small CBOs whose size and complexity do not warrant a full scale internal audit function may rely on regular reviews of essential internal controls conducted by other institution personnel. Given the importance of appropriate internal controls to institutions of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should management's responses to the findings. In addition, communication channels should allow for adverse or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

In evaluating internal controls, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the institution's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for risk management and for monitoring adherence to policies, procedures, and limits.
- Internal audit or other control functions, such as loan review and compliance, provide for independence and objectivity.
- The official organizational structures reflect actual operating practices and management responsibilities and authority over a particular business line or activity.
- Financial, operational, risk management, and regulatory reports are reliable, accurate, and timely; and wherever applicable, material exceptions are noted and promptly investigated or remediated.
- Policies and procedures for control functions support compliance with applicable laws, rules, regulations, or other supervisory requirements.
- Internal controls and information systems are adequately tested and reviewed; the coverage, procedures, findings, and responses to audits, regulatory examinations, and other review tests are adequately documented; identified material weaknesses are given appropriate and timely, high-level attention; and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's board of directors, or audit committee, and senior management are responsible for developing and implementing an effective system of internal controls and that the internal controls are operating effectively.

Conclusions

Examiners are expected to assess risk management for an institution and assign formal ratings of "risk management" as described in this manual for state member banks, the *Bank Holding Company Manual* for holding companies, and the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*.[9] In

8. Given the importance of the internal audit function, several additional policy statements have been issued. For comprehensive guidance on internal audit, see SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and its Outsourcing" and for institutions with more than $10 billion in assets, see SR-13-1/ CA-13-1, "Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing."

9. Refer to the section entitled, "Overall Conclusions Regarding Condition of the Bank: Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating," of this manual; the RFI Ratings section of the *Bank Holding Company Supervision Manual*; and the "Rating System for U.S. Branches and Agencies of Foreign Banking

reports of examination or inspection, and in transmittal letters to the boards of directors of state member banks, holding companies, and to the FBO officer of the U.S. operations, examination staff should specifically reference the types and nature of corrective actions that need to be taken by an institution to address noted risk management and internal control deficiencies. Where appropriate, the Federal Reserve will advise an institution that supervisory action will be initiated, if the institution fails to timely remediate risk management weaknesses when such failures create the potential for serious losses or if material deficiencies or situations threaten its safety and soundness. Such supervisory actions may include formal enforcement actions against the institution, or its responsible officers and directors, or both, and would require the immediate implementation of all necessary corrective measures.

If bank or holding company subsidiaries are regulated by another federal banking agency, Federal Reserve examiners should rely to the fullest extent possible on the conclusions drawn by relevant regulators regarding risk management. See also, SR-16-4, “Relying on the Work of the Regulators of the Subsidiary Insured Depository Institution(s) of Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of Less than $100 Billion.”

Organizations” section of the *Examination Manual for U.S. Branches and Agencies of Foreign Banking Organizations*. For relevant savings and loan holding companies, see the RFI Ratings section of the *Bank Holding Company Supervision Manual* and SR-14-9, “Incorporation of Federal Reserve Policies into the Savings and Loan Holding Company Supervision Program.”

APPLICABILITY

The guidance in this section largely is based on SR-95-51, “Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies.” This risk management guidance applies to the supervision of state member banks and bank holding companies with greater than $100 billion in total consolidated assets.

SR-95-51 instituted an explicit risk-management rating requirement to be assigned for examinations commencing on or after January 2, 1996. The risk-management rating applies to all state member banks, regardless of their size. For more information on this risk-management rating, see this manual’s section entitled, “Uniform Financial Institutions Rating System and the Federal Reserve’s Risk Management Rating.”

INTRODUCTION

The Federal Reserve places significant supervisory emphasis on the adequacy of an institution’s management of risk, including its system of internal controls, when assessing the condition of an organization. An institution’s failure to establish a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business has long been considered unsafe-and-unsound conduct. Principles of sound management should apply to the entire spectrum of risks facing a banking institution, including, but not limited to, credit, market, liquidity, operational, legal, and reputational risk.

- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Market risk* is the risk to a financial institution’s condition resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- *Liquidity risk* is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as “funding liquidity risk”), or that it cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as “market liquidity risk”).
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.
- *Legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of an institution.
- *Reputational risk* is the potential that negative publicity regarding an institution’s business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

In practice, an institution’s business activities present various combinations and concentrations of these risks, depending on the nature and scope of the particular activity. The following discussion provides guidelines for determining the quality of bank management’s formal or informal systems for identifying, measuring, and containing these risks.

ELEMENTS OF RISK MANAGEMENT

When evaluating the quality of risk management as part of the evaluation of the overall quality of management, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system:
- active board and senior management oversight
- adequate policies, procedures, and limits
- adequate risk measurement, risk monitoring, and management information systems
- comprehensive internal controls

Examiners should recognize that the considerations specified in these guidelines are intended only to assist in the evaluation of risk-management practices, and not as a checklist of requirements for each institution. Moreover, while all bank holding companies should be able to assess the major risks of the consolidated organization, examiners should expect parent companies that centrally manage the operations and functions of their subsidiary banks to have more comprehensive, detailed, and developed risk-management systems than companies that delegate the management of risks to relatively autonomous banking subsidiaries.

Adequate risk-management programs can vary considerably in sophistication, depending on the size and complexity of the institution and the level of risk that it accepts. For smaller institutions engaged solely in traditional banking activities and whose senior managers and directors are actively involved in the details of day-to-day operations, relatively basic risk-management systems may be adequate. In such institutions, these systems may consist only of written policies addressing material areas of operations, such as lending or investing, basic internal control systems, and a limited set of management and board reports. However, large, multinational organizations will require far more elaborate and formal risk-management systems to address their broader and typically more-complex range of financial activities, and to provide senior managers and directors with the information they need to monitor and direct day-to-day activities. In addition to the banking organization's market and credit risks, risk-management systems should encompass the organization's trust and fiduciary activities, including investment advisory services, mutual funds, and securities lending.

The risk-management processes of large banking organizations would typically contain detailed guidelines that set specific prudential limits on the principal types of risks relevant to their activities worldwide. Furthermore, because of the diversity of their activities and the geographic dispersion of their operations, these institutions will require timely and relatively more sophisticated reporting systems in order to manage their risks properly. These reporting systems, in turn, should comprise an adequate array of reports that provide the levels of detail about risk exposures that are relevant to the duties and responsibilities of individual managers and directors.

Such extensive systems of large institutions will naturally require frequent monitoring and testing by independent control areas and internal, as well as external, auditors to ensure the integrity of the information used by senior officials in overseeing compliance with policies and limits. The risk-management systems or units of such institutions must also be sufficiently independent of the business lines in order to ensure an adequate separation of duties and the avoidance of conflicts of interest.

Board Oversight and the Role of Senior Management

Boards of directors have ultimate responsibility for the level of risk taken by their institutions. Accordingly, they should approve the overall business strategies and significant policies of their organizations, including those related to managing and taking risks, and should also ensure that senior management is fully capable of managing the activities that their institutions conduct. While all boards of directors are responsible for understanding the nature of the risks significant to their organizations and overseeing and holding senior management accountable for maintaining an effective risk-management framework, the level of technical knowledge required of directors may vary depending on the particular circumstances at the institution.

Directors of large banking organizations that conduct a broad range of technically complex activities, for example, cannot be expected to understand the full details of their institutions' activities or the precise ways risks are measured and controlled. They should, however, have a clear understanding of the types of risks to which their institutions are exposed and senior management should provide reports to the board of directors that identify and summarize the size, complexity, and significance of the risks in terms that are meaningful to them. In fulfilling this responsibility, directors should take steps to develop an appropriate understanding of the risks their institutions face, possibly through briefings from auditors and experts external to the organization. Using this knowledge and information, directors should provide clear guidance regarding the level of exposures acceptable to their institutions and have the responsibility to ensure that senior management implements the procedures and controls necessary to comply with adopted policies.

Directors of institutions that conduct more traditional and less complicated business activities may require significantly less knowledge of complex financial transactions or capital markets.

Senior management is responsible for implementing strategies in a manner that manages, monitors, and mitigates risks associated with each strategy and that ensures compliance with laws and regulations on both a long-term and day-to-day basis. Accordingly, senior management should be fully involved in the activities of their institutions and possess sufficient knowledge of all major business lines to ensure that appropriate policies, controls, and risk monitoring systems are in place and that accountability and lines of authority are clearly delineated. Senior management is also responsible for establishing and communicating a strong awareness of and need for effective internal controls and high ethical standards. Meeting these responsibilities requires senior managers of a bank or bank holding company to have a thorough understanding of banking and financial market activities and detailed knowledge of the activities their institution conducts, including the nature of internal controls necessary to limit the related risks.

When assessing the quality of the oversight by boards of directors and the managing, monitoring, and mitigating of risk by senior management, examiners should consider whether the institution follows policies and practices such as those described below:

- The board makes appropriate efforts to remain informed about risks inherent to the institution's activities and holds senior management accountable as financial markets, risk-management practices, and the bank holding company's activities evolve.
- The board reviews and approves significant policies to limit risks inherent in the institution's lending, investing, trading, trust, fiduciary, and other significant activities or products.
- The board reviews and approves significant risk-exposure limits to conform to any changes in the institution's strategies, reviews new products, and reacts to changes in market conditions.
- Senior management have identified and have a clear understanding and working knowledge of the types of risks inherent in the institution's activities, and they make appropriate efforts to remain informed about these risks as financial markets, risk-management practices, and the institution's activities evolve.
- Senior management is sufficiently familiar with and is using adequate recordkeeping and reporting systems to measure and monitor the major sources of risk to the organization.
- Senior management ensures that its lines of business are managed and staffed by personnel whose knowledge, experience, and expertise is consistent with the nature and scope of the banking organization's activities.
- Senior management ensures that the depth of staff resources is sufficient to operate and soundly manage the institution's activities, and ensures that employees have the integrity, ethical values, and competence that are consistent with a prudent management philosophy and operating style.
- Senior management at all levels provides adequate supervision of the day-to-day activities of officers and employees, including management supervision of senior officers or heads of business lines.
- Senior management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the organization is active.
- Before embarking on new activities or introducing new products, senior management identifies and reviews all risks associated with the activities or products and ensures that the infrastructure and internal controls necessary to manage the related risks are in place.

Adequate Policies, Procedures, and Limits

An institution's directors should set clear, aligned, and consistent direction regarding the firm's strategy and risk appetite. Once risks are properly identified, the institution's policies and its fully articulated procedures provide detailed guidance for the day-to-day implementation of broad business strategies, and generally include limits designed to shield the organization from excessive and imprudent risks. While all banking organizations should have policies and procedures that address their significant activities and risks, the coverage and level of detail embodied in these statements will vary among institutions. A smaller, less complex institution that has effective management that is heavily involved in day-to-day operations generally would be expected to have only basic policies addressing the significant areas of operations and setting forth a limited set of requirements and procedures. In a larger institution, where senior managers must rely on widely dispersed staffs to implement strategies in an extended range of potentially complex businesses, more detailed policies and related procedures would generally be expected. In either case, however, senior management is expected to ensure that policies and procedures address the material areas of risk to an institution and that they are modified when necessary to respond to significant changes in the banking organization's activities or business conditions.

Examiners should consider the following when evaluating the adequacy of a banking organization's policies, procedures, and limits:

- The institution's policies, procedures, and limits provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending, investing, trading, trust, fiduciary, and other significant activities.
- The policies, procedures, and limits are consistent with senior management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization.
- Policies clearly delineate accountability and lines of authority across the institution's activities.
- Policies provide for the review of new activities to ensure that the financial institution has the necessary infrastructures to identify, monitor, and control risks associated with an activity before it is initiated.

Adequate Risk Monitoring and Management Information Systems

Effective risk monitoring requires institutions to identify and measure all material risk exposures. Consequently, risk monitoring activities must be supported by information systems that provide senior managers and directors with timely reports on the financial condition, operating performance, and risk exposure of the consolidated organization as well as with regular and sufficiently detailed reports for line managers engaged in the day-to-day management of the organization's activities.

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

When assessing the adequacy of an institution's risk measurement and monitoring, as well as its management reports and information systems, examiners should consider whether these conditions exist:

- The institution's risk monitoring practices and reports address all of its material risks.
- Key assumptions, data sources, and procedures used in measuring and monitoring risk are appropriate and adequately documented, and are tested for reliability on an ongoing basis.
- Reports and other forms of communication are consistent with the banking organization's activities; are structured to monitor exposures and compliance with established limits, goals, or objectives; and, as appropriate, compare actual versus expected performance.
- Reports to senior management or to the institution's directors are accurate and timely, and contain sufficient information for decision makers to identify any adverse trends and to evaluate adequately the level of risk faced by the institution.

Adequate Internal Controls

An institution's internal control structure is critical to the safe-and-sound functioning of the organization generally and to its risk-management system, in particular. Establishing and maintaining an effective system of controls, including the enforcement of official lines of authority and the appropriate separation of duties—such as trading, custodial, and back-office—is one of management's more important responsibilities.

Appropriately segregating duties is a fundamental and essential element of a sound risk management and internal control system. Failure to implement and maintain an adequate separation of duties can constitute an unsafe-and-unsound practice and possibly lead to serious losses or otherwise compromise the financial integrity of the institution. Serious lapses or deficiencies in internal controls, including inadequate segregation of duties, may warrant supervisory action, including formal enforcement action.

When properly structured, a system of internal controls promotes effective operations and reliable financial and regulatory reporting, safeguards assets, and helps to ensure compliance with relevant laws, regulations, and institutional policies. Ideally, internal controls are tested by an independent internal auditor who reports directly either to the institution's board of directors or its designated committee, which is typically the audit committee. However, smaller institutions whose size and complexity do not warrant a full-scale internal audit function may rely on regular reviews of essential internal controls conducted by other institution personnel. Personnel performing these reviews generally should be independent of the function they are assigned to review. Given the importance of appropriate internal controls to banking organizations of all sizes and risk profiles, the results of audits or reviews, whether conducted by an internal auditor or by other personnel, should be adequately documented, as should senior management's responses to them. In addition, communication channels should exist that allow negative or sensitive findings to be reported directly to the board of directors or to the relevant board committee.

When evaluating the adequacy of a financial institution's internal controls and audit procedures, examiners should consider whether these conditions are met:

- The system of internal controls is appropriate to the type and level of risks posed by the nature and scope of the organization's activities.
- The institution's organizational structure establishes clear lines of authority and responsibility for monitoring adherence to policies, procedures, and limits.
- Reporting lines for the control areas are independent from the business lines, and there is adequate separation of duties throughout the organization—such as duties relating to trading, custodial, and back-office activities.
- Official organizational structures reflect actual operating practices.
- Financial, operational, and regulatory reports are reliable, accurate, and timely, and, when applicable, exceptions are noted and promptly investigated.
- Adequate procedures exist for ensuring compliance with applicable laws and regulations.
- Internal audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed. The coverage of, procedures for, and findings and responses to audits and review tests are adequately documented. Identified material weaknesses are given appropriate and timely high-level attention, and management's actions to address material weaknesses are objectively verified and reviewed.
- The institution's audit committee or board of directors engages in robust inquiry into the effectiveness of internal audits and other control-review activities regularly.

The risk-management rating is to be reflected in the institution's overall "Management" rating. The risk-management rating should be consistent with the stated rating criteria of "1" through "5." For more information see the section entitled, "Uniform Financial Institutions Rating System and the Federal Reserve's Risk Management Rating."

Banking organizations should be attentive to the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused and should address those consequences through active model risk management. The key aspects of an effective model risk-management framework are described in more detail below, including robust model development, implementation, and use; effective validation; and sound governance, policies, and controls. (See SR-11-7.)

INTRODUCTION—PART I

Banks rely heavily on quantitative analysis and models in most aspects of financial decision making.[1] They routinely use models for a broad range of activities, including underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many other activities. In recent years, banks have applied models to more complex products and with more ambitious scope, such as enterprise-wide risk measurement, while the markets in which they are used have also broadened and changed. Changes in regulation have spurred some of the recent developments, particularly the U.S. regulatory capital rules for market, credit, and operational risk based on the framework developed by the Basel Committee on Banking Supervision. Even apart from these regulatory considerations, however, banks have been increasing the use of data-driven, quantitative decision making tools for a number of years.

The expanding use of models in all aspects of banking reflects the extent to which models can improve business decisions, but models also come with costs. There is the direct cost of devoting resources to develop and implement models properly. There are also the potential indirect costs of relying on models, such as the possible adverse consequences (including financial loss) of decisions based on models that are incorrect or misused. Those consequences should be addressed by active management of model risk.

This guidance describes the key aspects of effective model risk management. Part II explains the purpose and scope of the guidance, and part III gives an overview of model risk management. Part IV discusses robust model development, implementation, and use. Part V describes the components of an effective validation framework. Part VI explains the salient features of sound governance, policies, and controls over model development, implementation, use, and validation. Part VII concludes.

PURPOSE AND SCOPE—PART II

The purpose of this section is to provide comprehensive guidance for banks on effective model risk management. Rigorous model validation plays a critical role in model risk management; however, sound development, implementation, and use of models are also vital elements. Furthermore, model risk management encompasses governance and control mechanisms such as board and senior management oversight, policies and procedures, controls and compliance, and an appropriate incentive and organizational structure.

Previous guidance and other publications issued by the Office of the Comptroller of the Currency (OCC) and the Federal Reserve on the use of models pay particular attention to model validation.[2] Based on supervisory and industry experience over the past several years, this document expands on existing guidance—most importantly by broadening the scope to include

1. Unless otherwise indicated, *banks* refers to national banks and all other institutions for which the Office of the Comptroller of the Currency is the primary supervisor, and to bank holding companies, state member banks, and all other institutions for which the Federal Reserve Board is the primary supervisor.

2. For instance, the OCC provided guidance on model risk, focusing on model validation, in OCC 2000-16 (May 30, 2000), other bulletins, and certain subject matter booklets of the *Comptroller's Handbook.* The Federal Reserve issued SR-09-01, "Application of the Market Risk Rule in Bank Holding Companies and State Member Banks," which highlights various concepts pertinent to model risk management, including standards for validation and review, model validation documentation, and back-testing. The Federal Reserve's *Trading and Capital-Markets Activities Manual* also discusses validation and model risk management. In addition, the advanced-approaches risk-based capital rules (12 CFR 3, Appendix C; 12 CFR 208, Appendix F; and 12 CFR 225, Appendix G) contain explicit validation requirements for subject banking organizations.

all aspects of model risk management. Many banks may already have in place a large portion of these practices, but all banks should ensure that internal policies and procedures are consistent with the risk-management principles and supervisory expectations contained in this guidance. Details may vary from bank to bank, as practical application of this guidance should be customized to be commensurate with a bank's risk exposures, its business activities, and the complexity and extent of its model use. For example, steps taken to apply this guidance at a community bank using relatively few models of only moderate complexity might be significantly less involved than those at a larger bank where use of models is more extensive or complex.

OVERVIEW OF MODEL RISK MANAGEMENT—PART III

For the purposes of this section, the term *model* refers to a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates. A *model* consists of three components: an information input component, which delivers assumptions and data to the model; a processing component, which transforms inputs into estimates; and a reporting component, which translates the estimates into useful business information. Models meeting this definition might be used for analyzing business strategies; informing business decisions; identifying and measuring risks; valuing exposures, instruments, or positions; conducting stress testing; assessing adequacy of capital; managing client assets; measuring compliance with internal limits; maintaining the formal control apparatus of the bank; meeting financial or regulatory reporting requirements; and issuing public disclosures. The definition of *model* also covers quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature.[3]

Models are simplified representations of real-world relationships among observed characteristics, values, and events. Simplification is inevitable, due to the inherent complexity of those relationships, but also intentional, to focus attention on particular aspects considered to be most important for a given model application. Model quality can be measured in many ways: precision, accuracy, discriminatory power, robustness, stability, and reliability, to name a few. Models are never perfect, and the appropriate metrics of quality, and the effort that should be put into improving quality, depend on the situation. For example, precision and accuracy are relevant for models that forecast future values, while discriminatory power applies to models that rank order risks. In all situations, it is important to understand a model's capabilities and limitations given its simplifications and assumptions.

The use of models invariably presents model risk, which is the potential for adverse consequences from decisions based on incorrect or misused model outputs and reports. Model risk can lead to financial loss, poor business and strategic decision making, or damage to a bank's reputation. Model risk occurs primarily for two reasons:

- The model may have fundamental errors and may produce inaccurate outputs when viewed against the design objective and intended business uses. The mathematical calculation and quantification exercise underlying any model generally involves application of theory, choice of sample design and numerical routines, selection of inputs and estimation, and implementation in information systems. Errors can occur at any point from design through implementation. In addition, shortcuts, simplifications, or approximations used to manage complicated problems could compromise the integrity and reliability of outputs from those calculations. Finally, the quality of model outputs depends on the quality of input data and assumptions, and errors in inputs or incorrect assumptions will lead to inaccurate outputs.
- The model may be used incorrectly or inappropriately. Even a fundamentally sound model producing accurate outputs consistent with the design objective of the model may exhibit high model risk if it is misapplied or misused. Models by their nature are simplifications of reality, and real-world events may prove those simplifications inappropriate. This is even more of a concern if a model is used outside the environment for which it was designed. Banks may do this intentionally as they apply

3. While outside the scope of this guidance, more qualitative approaches used by banking organizations—i.e., those *not* defined as models according to this guidance—should also be subject to a rigorous control process.

existing models to new products or markets, or inadvertently as market conditions or customer behavior changes. Decision makers need to understand the limitations of a model to avoid using it in ways that are not consistent with the original intent. Limitations come in part from weaknesses in the model due to its various shortcomings, approximations, and uncertainties. Limitations are also a consequence of assumptions underlying a model that may restrict the scope to a limited set of specific circumstances and situations.

Model risk should be managed like other types of risk. Banks should identify the sources of risk and assess the magnitude. Model risk increases with greater model complexity, higher uncertainty about inputs and assumptions, broader use, and larger potential impact. Banks should consider risk from individual models and in the aggregate. Aggregate model risk is affected by interaction and dependencies among models; reliance on common assumptions, data, or methodologies; and any other factors that could adversely affect several models and their outputs at the same time. With an understanding of the source and magnitude of model risk in place, the next step is to manage it properly.

A guiding principle for managing model risk is "effective challenge" of models, that is, critical analysis by objective, informed parties who can identify model limitations and assumptions and produce appropriate changes. Effective challenge depends on a combination of incentives, competence, and influence. Incentives to provide effective challenge to models are stronger when there is greater separation of that challenge from the model development process and when challenge is supported by well-designed compensation practices and corporate culture. Competence is a key to effectiveness since technical knowledge and modeling skills are necessary to conduct appropriate analysis and critique. Finally, challenge may fail to be effective without the influence to ensure that actions are taken to address model issues. Such influence comes from a combination of explicit authority, stature within the organization, and commitment and support from higher levels of management.

Even with skilled modeling and robust validation, model risk cannot be eliminated, so other tools should be used to manage model risk effectively. Among these are establishing limits on model use, monitoring model performance, adjusting or revising models over time, and supplementing model results with other analysis and information. Informed conservatism, in either the inputs or the design of a model or through explicit adjustments to outputs, can be an effective tool, though not an excuse to avoid improving models.

As is generally the case with other risks, materiality is an important consideration in model risk management. If at some banks the use of models is less pervasive and has less impact on their financial condition, then those banks may not need as complex an approach to model risk management in order to meet supervisory expectations. However, where models and model output have a material impact on business decisions, including decisions related to risk management and capital and liquidity planning, and where model failure would have a particularly harmful impact on a bank's financial condition, a bank's model risk-management framework should be more extensive and rigorous.

Model risk management begins with robust model development, implementation, and use. Another essential element is a sound model validation process. A third element is governance, which sets an effective framework with defined roles and responsibilities for clear communication of model limitations and assumptions, as well as the authority to restrict model usage. Each of these elements is discussed in the following sections.

MODEL DEVELOPMENT, IMPLEMENTATION, AND USE—PART IV

Model risk management should include disciplined and knowledgeable development and implementation processes that are consistent with the situation and goals of the model user and with bank policy. Model development is not a straightforward or routine technical process. The experience and judgment of developers, as much as their technical knowledge, greatly influence the appropriate selection of inputs and processing components. The training and experience of developers exercising such judgment affects the extent of model risk. Moreover, the modeling exercise is often a multidisciplinary activity drawing on economics, finance, statistics, mathematics, and other fields. Models are employed in real-world markets and events and, therefore, should be tailored for specific applications and informed by business uses. In addition, a considerable amount of subjective judgment is exercised at various stages of model development, implementation, use, and validation. It is important for decision makers to recognize that this subjectivity elevates the importance of sound and comprehensive model risk-management processes.[4]

Model Development and Implementation

An effective development process begins with a clear statement of purpose to ensure that model development is aligned with the intended use. The design, theory, and logic underlying the model should be well documented and generally supported by published research and sound industry practice. The model methodologies and processing components that implement the theory, including the mathematical specification and the numerical techniques and approximations, should be explained in detail with particular attention to merits and limitations. Developers should ensure that the components work as intended, are appropriate for the intended business purpose, and are conceptually sound and mathematically and statistically correct. Comparison with alternative theories and approaches is a fundamental component of a sound modeling process.

The data and other information used to develop a model are of critical importance; there should be rigorous assessment of data quality and relevance, and appropriate documentation. Developers should be able to demonstrate that such data and information are suitable for the model and that they are consistent with the theory behind the approach and with the chosen methodology. If data proxies are used, they should be carefully identified, justified, and documented. If data and information are not representative of the bank's portfolio or other characteristics, or if assumptions are made to adjust the data and information, these factors should be properly tracked and analyzed so that users are aware of potential limitations. This is particularly important for external data and information (from a vendor or outside party), especially as they relate to new products, instruments, or activities.

An integral part of model development is testing, in which the various components of a model and its overall functioning are evaluated to determine whether the model is performing as intended. Model testing includes checking the model's accuracy, demonstrating that the model is robust and stable, assessing potential limitations, and evaluating the model's behavior over a range of input values. It should also assess the impact of assumptions and identify situations where the model performs poorly or becomes unreliable. Testing should be applied to actual circumstances under a variety of market conditions, including scenarios that are outside the range of ordinary expectations, and should encompass the variety of products or applications for which the model is intended. Extreme values for inputs should be evaluated to identify any boundaries of model effectiveness. The impact of model results on other models that rely on those results as inputs should also be evaluated. Included in testing activities should be the purpose, design, and execution of test plans, summary results with commentary and evaluation, and detailed analysis of informative samples. Testing activities should be appropriately documented.

The nature of testing and analysis will depend on the type of model and will be judged by different criteria depending on the context. For example, the appropriate statistical tests depend on specific distributional assumptions and the purpose of the model. Furthermore, in many cases statistical tests cannot unambiguously reject false hypotheses or accept true ones based on sample information. Different tests have different strengths and weaknesses under different conditions. Any single test is rarely sufficient, so banks should apply a variety of tests to develop a sound model.

Banks should ensure that the development of the more judgmental and qualitative aspects of their models is also sound. In some cases, banks may take statistical output from a model and modify it with judgmental or qualitative adjustments as part of model development. While such practices may be appropriate, banks should ensure that any such adjustments made as part of the development process are conducted in an

4. Smaller banks that rely on vendor models may be able to satisfy the standards in this guidance without an in-house staff of technical, quantitative model developers. However, even if a bank relies on vendors for basic model development, the bank should still choose the particular models and variables that are appropriate to its size, scale, and lines of business and ensure the models are appropriate for the intended use.

appropriate and systematic manner and are well documented.

Models typically are embedded in larger information systems that manage the flow of data from various sources into the model and handle the aggregation and reporting of model outcomes. Model calculations should be properly coordinated with the capabilities and requirements of information systems. Sound model risk management depends on substantial investment in supporting systems to ensure data and reporting integrity, together with controls and testing to ensure proper implementation of models, effective systems integration, and appropriate use.

Model Use

Model use provides additional opportunity to test whether a model is functioning effectively and to assess its performance over time as conditions and model applications change. It can serve as a source of productive feedback and insights from a knowledgeable internal constituency with strong interest in having models that function well and reflect economic and business realities. Model users can provide valuable business insight during the development process. In addition, business managers affected by model outcomes may question the methods or assumptions underlying the models, particularly if the managers are significantly affected by, and do not agree with, the outcome. Such questioning can be healthy if it is constructive and causes model developers to explain and justify the assumptions and design of the models.

However, challenge from model users may be weak if the model does not materially affect their results, if the resulting changes in models are perceived to have adverse effects on the business line, or if change in general is regarded as expensive or difficult. User challenges also tend not to be comprehensive because they focus on aspects of models that have the most direct impact on the user's measured business performance or compensation, and thus may ignore other elements and applications of the models. Finally, such challenges tend to be asymmetric because users are less likely to challenge an outcome that results in an advantage for them. Indeed, users may incorrectly believe that model risk is low simply because outcomes from model-based decisions appear favorable to the institution. Thus, the nature and motivation behind model users' input should be evaluated carefully, and banks should also solicit constructive suggestions and criticism from sources independent of the line of business using the model.

Reports used for business decision making play a critical role in model risk management. Such reports should be clear and comprehensible and take into account the fact that decision makers and modelers often come from quite different backgrounds and may interpret the contents in different ways. Reports that provide a range of estimates for different input-value scenarios and assumption values can give decision makers important indications of the model's accuracy, robustness, and stability as well as information on model limitations.

An understanding of model uncertainty and inaccuracy and a demonstration that the bank is accounting for them appropriately are important outcomes of effective model development, implementation, and use. Because they are by definition imperfect representations of reality, all models have some degree of uncertainty and inaccuracy. These can sometimes be quantified, for example, by an assessment of the potential impact of factors that are unobservable or not fully incorporated in the model, or by the confidence interval around a statistical model's point estimate. Indeed, using a range of outputs, rather than a simple point estimate, can be a useful way to signal model uncertainty and avoid spurious precision. At other times, only a qualitative assessment of model uncertainty and inaccuracy is possible. In either case, it can be prudent for banks to account for model uncertainty by explicitly adjusting model inputs or calculations to produce more severe or adverse model output in the interest of conservatism. Accounting for model uncertainty can also include judgmental conservative adjustments to model output, placing less emphasis on that model's output, or ensuring that the model is only used when supplemented by other models or approaches.[5]

While conservative use of models is prudent in general, banks should be careful in applying conservatism broadly or claiming to make conservative adjustments or add-ons to address

5. To the extent that models are used to generate amounts included in public financial statements, any adjustments for model uncertainty must comply with generally accepted accounting principles.

model risk, because the impact of such conservatism in complex models may not be obvious or intuitive. Model aspects that appear conservative in one model may not be truly conservative compared with alternative methods. For example, simply picking an extreme point on a given modeled distribution may not be conservative if the distribution was misestimated or misspecified in the first place. Furthermore, initially conservative assumptions may not remain conservative over time. Therefore, banks should justify and substantiate claims that model outputs are conservative with a definition and measurement of that conservatism that is communicated to model users. In some cases, sensitivity analysis or other types of stress testing can be used to demonstrate that a model is indeed conservative. Another way in which banks may choose to be conservative is to hold an additional cushion of capital to protect against potential losses associated with model risk. However, conservatism can become an impediment to proper model development and application if it is seen as a solution that dissuades the bank from making the effort to improve the model; in addition, excessive conservatism can lead model users to discount the model outputs.

As previously explained, robust model development, implementation, and use is important to model risk management. But it is not enough for model developers and users to understand and accept the model. Because model risk is ultimately borne by the bank as a whole, the bank should objectively assess model risk and the associated costs and benefits using a sound model-validation process.

MODEL VALIDATION—PART V

Model validation is the set of processes and activities intended to verify that models are performing as expected, in line with their design objectives and business uses. Effective validation helps ensure that models are sound. It also identifies potential limitations and assumptions and assesses their possible impact. As with other aspects of effective challenge, model validation should be performed by staff with appropriate incentives, competence, and influence.

All model components, including input, processing, and reporting, should be subject to validation; this applies equally to models developed in-house and to those purchased from, or developed by, vendors or consultants. The rigor and sophistication of validation should be commensurate with the bank's overall use of models, the complexity and materiality of its models, and the size and complexity of the bank's operations.

Validation involves a degree of independence from model development and use. Generally, validation should be done by people who are not responsible for development or use and do not have a stake in whether a model is determined to be valid. Independence is not an end in itself but rather helps ensure that incentives are aligned with the goals of model validation. While independence may be supported by separation of reporting lines, it should be judged by actions and outcomes, since there may be additional ways to ensure objectivity and prevent bias. As a practical matter, some validation work may be most effectively done by model developers and users; it is essential, however, that such validation work be subject to critical review by an independent party, who should conduct additional activities to ensure proper validation. Overall, the quality of the process is judged by the manner in which models are subject to critical review. This could be determined by evaluating the extent and clarity of documentation, the issues identified by objective parties, and the actions taken by management to address model issues.

In addition to independence, banks can support appropriate incentives in validation through compensation practices and performance evaluation standards that are tied directly to the quality of model validations and the degree of critical, unbiased review. In addition, corporate culture plays a role if it establishes support for objective thinking and encourages questioning and challenging of decisions.

Staff doing validation should have the requisite knowledge, skills, and expertise. A high level of technical expertise may be needed because of the complexity of many models, both in structure and in application. These staff also should have a significant degree of familiarity with the line of business using the model and the model's intended use. A model's developer is an important source of information but cannot be relied on as an objective or sole source on which to base an assessment of model quality.

Staff conducting validation work should have explicit authority to challenge developers and users and to elevate their findings, including issues and deficiencies. The individual or unit to whom those staff report should have sufficient influence or stature within the bank to ensure that any issues and deficiencies are appropriately addressed in a timely and substantive manner. Such influence can be reflected in reporting lines, title, rank, or designated responsibilities. Influence may be demonstrated by a pattern of actual instances in which models, or the use of models, have been appropriately changed as a result of validation.

The range and rigor of validation activities conducted prior to first use of a model should be in line with the potential risk presented by use of the model. If significant deficiencies are noted as a result of the validation process, use of the model should not be allowed or should be permitted only under very tight constraints until those issues are resolved. If the deficiencies are too severe to be addressed within the model's framework, the model should be rejected. If it is not feasible to conduct necessary validation activities prior to model use because of data paucity or other limitations, that fact should be documented and communicated in reports to users, senior management, and other relevant parties. In such cases, the uncertainty about the results that the model produces should be mitigated by other compensating controls. This is particularly applicable to new models and to the use of existing models in new applications.

Validation activities should continue on an ongoing basis after a model goes into use, to track known model limitations and to identify any new ones. Validation is an important check on model use during periods of benign economic and financial conditions, when estimates of risk and potential loss can become overly optimistic, and when the data at hand may not fully reflect more stressed conditions. Ongoing validation activities help to ensure that changes in markets, products, exposures, activities, clients, or business practices do not create new model limitations. For example, if credit risk models do not incorporate underwriting changes in a timely manner, flawed and costly business decisions could be made before deterioration in model performance becomes apparent.

Banks should conduct a periodic review—at least annually but more frequently if warranted—of each model to determine whether it is working as intended and if the existing validation activities are sufficient. Such a determination could simply affirm previous validation work, suggest updates to previous validation activities, or call for additional validation activities. Material changes to models should also be subject to validation. It is generally good practice for banks to ensure that all models undergo the full validation process, as described in the following section, at some fixed interval, including updated documentation of all activities.

Effective model validation helps reduce model risk by identifying model errors, corrective actions, and appropriate use. It also provides an assessment of the reliability of a given model, based on its underlying assumptions, theory, and methods. In this way, it provides information about the source and extent of model risk. Validation also can reveal deterioration in model performance over time and can set thresholds for acceptable levels of error, through analysis of the distribution of outcomes around expected or predicted values. If outcomes fall consistently outside this acceptable range, then the models should be redeveloped.

Key Elements of Comprehensive Validation

An effective validation framework should include three core elements:

- Evaluation of conceptual soundness, including developmental evidence
- Ongoing monitoring, including process verification and benchmarking
- Outcomes analysis, including back-testing

Evaluation of Conceptual Soundness

This first element involves assessing the quality of the model design and construction. It entails review of documentation and empirical evidence supporting the methods used and variables selected for the model. Documentation and testing should convey an understanding of model limitations and assumptions. Validation should ensure that judgment exercised in model design and construction is well informed, carefully considered, and consistent with published research and with sound industry practice. Developmental evidence should be reviewed before a model goes into use and also as part of the ongoing validation process, in particular whenever there is a material change in the model.

A sound development process will produce documented evidence in support of all model choices, including the overall theoretical construction, key assumptions, data, and specific mathematical calculations. As part of model validation, those model aspects should be subjected to critical analysis by both evaluating the quality and extent of developmental evidence and conducting additional analysis and testing as necessary. Comparison to alternative theories and approaches should be included. Key assumptions and the choice of variables should be assessed, with analysis of their impact on model outputs and particular focus on any potential limitations. The relevance of the data used to build the model should be evaluated to ensure that it is reasonably representative of the bank's portfolio or market conditions, depending on the type of model. This is an especially important exercise when a bank uses external data or the model is used for new products or activities.

Where appropriate to the particular model, banks should employ sensitivity analysis in model development and validation to check the impact of small changes in inputs and parameter values on model outputs to make sure they fall within an expected range. Unexpectedly large changes in outputs in response to small changes in inputs can indicate an unstable model. Varying several inputs simultaneously as part of sensitivity analysis can provide evidence of unexpected interactions, particularly if the interactions are complex and not intuitively clear. Banks benefit from conducting model stress testing to check performance over a wide range of inputs and parameter values, including extreme values, to verify that the model is robust. Such testing helps establish the boundaries of model performance by identifying the acceptable range of inputs as well as conditions under which the model may become unstable or inaccurate.

Management should have a clear plan for using the results of sensitivity analysis and other quantitative testing. If testing indicates that the model may be inaccurate or unstable in some circumstances, management should consider modifying certain model properties, putting less reliance on its outputs, placing limits on model use, or developing a new approach.

Qualitative information and judgment used in model development should be evaluated, including the logic, judgment, and types of information used, to establish the conceptual soundness of the model and set appropriate conditions for its use. The validation process should ensure that qualitative, judgmental assessments are conducted in an appropriate and systematic manner, are well supported, and are documented.

Ongoing Monitoring

The second core element of the validation process is ongoing monitoring. Such monitoring confirms that the model is appropriately implemented and is being used and is performing as intended.

Ongoing monitoring is essential to evaluate whether changes in products, exposures, activities, clients, or market conditions necessitate adjustment, redevelopment, or replacement of the model and to verify that any extension of the model beyond its original scope is valid. Any model limitations identified in the development stage should be regularly assessed over time, as part of ongoing monitoring. Monitoring begins when a model is first implemented in production systems for actual business use. This monitoring should continue periodically over time, with a frequency appropriate to the nature of the model, the availability of new data or modeling approaches, and the magnitude of the risk involved. Banks should design a program of ongoing testing and evaluation of model performance along with procedures for responding to any problems that appear. This program should include process verification and benchmarking.

Process verification checks that all model components are functioning as designed. It includes verifying that internal and external data inputs continue to be accurate, complete, consistent with model purpose and design, and of the highest quality available. Computer code implementing the model should be subject to rigorous quality and change control procedures to ensure that the code is correct, that it cannot be altered except by approved parties, and that all changes are logged and can be audited. System integration can be a challenge and deserves special attention because the model processing component often draws from various sources of data, processes large amounts of data, and then feeds into multiple data repositories and reporting systems. User-developed applications, such as spreadsheets or ad hoc database applications used to generate quantitative estimates, are particularly prone to model risk. As the content or composition of information changes over time, systems may need to be updated to reflect any changes in the data or its use. Reports derived from model outputs should be reviewed as part of validation to verify that they are accurate, complete, and informative, and that they contain appropriate indicators of model performance and limitations.

Many of the tests employed as part of model development should be included in ongoing monitoring and be conducted on a regular basis to incorporate additional information as it becomes available. New empirical evidence or theoretical research may suggest the need to modify or even replace original methods. Analysis of the integrity and applicability of internal and external information sources, including information provided by third-party vendors, should be performed regularly.

Sensitivity analysis and other checks for robustness and stability should likewise be repeated periodically. They can be as useful during ongoing monitoring as they are during model development. If models only work well for certain ranges of input values, market conditions, or other factors, they should be monitored to identify situations where these constraints are approached or exceeded.

Ongoing monitoring should include the analysis of overrides with appropriate documentation. In the use of virtually any model, there will be cases where model output is ignored, altered, or reversed based on the expert judgment of model users. Such overrides are an indication that, in some respect, the model is not performing as intended or has limitations. Banks should evaluate the reasons for overrides and track and analyze override performance. If the rate of overrides is high, or if the override process consistently improves model performance, it is often a sign that the underlying model needs revision or redevelopment.

Benchmarking is the comparison of a given model's inputs and outputs to estimates from alternative internal or external data or models. It can be incorporated in model development as well as in ongoing monitoring. For credit-risk models, examples of benchmarks include models from vendor firms or industry consortia and data from retail credit bureaus. Pricing models for securities and derivatives often can be compared with alternative models that are more accurate or comprehensive but also too time-consuming to run on a daily basis. Whatever the source, benchmark models should be rigorous, and benchmark data should be accurate and complete to ensure a reasonable comparison.

Discrepancies between the model output and benchmarks should trigger investigation into the sources and degree of the differences, and examination of whether they are within an expected or appropriate range given the nature of the comparison. The results of that analysis may suggest revisions to the model. However, differences do not necessarily indicate that the model is in error. The benchmark itself is an alternative prediction, and the differences may be due to the different data or methods used. If the model and the benchmark match well, that is evidence in favor of the model, but it should be interpreted with caution so the bank does not get a false degree of comfort.

Outcomes Analysis

The third core element of the validation process is outcomes analysis, a comparison of model outputs to corresponding actual outcomes. The precise nature of the comparison depends on the objectives of a model and might include an assessment of the accuracy of estimates or forecasts, an evaluation of rank-ordering ability, or other appropriate tests. In all cases, such comparisons help to evaluate model performance by establishing expected ranges for those actual outcomes in relation to the intended objectives and assessing the reasons for observed variation between the two. If outcomes analysis produces evidence of poor performance, the bank should take action to address those issues. Outcomes analysis typically relies on statistical tests or other quantitative measures. It can also include expert judgment to check the intuition behind the outcomes and confirm that the results make sense. When a model itself relies on expert judgment, quantitative outcomes analysis helps to evaluate the quality of that judgment. Outcomes analysis should be conducted on an ongoing basis to test whether the model continues to perform in line with design objectives and business uses.

A variety of quantitative and qualitative testing and analytical techniques can be used in outcomes analysis. The choice of technique should be based on the model's methodology, and its complexity, data availability, and the magnitude of potential model risk to the bank. Outcomes analysis should involve a range of tests because any individual test will have weaknesses. For example, some tests are better at checking a model's ability to rank-order or segment observations on a relative basis, whereas others are better at checking absolute forecast accuracy. Tests should be designed for each situation, as not all will be effective or feasible in every circumstance, and attention should be paid to choosing the appropriate type of outcomes analysis for a particular model.

Models are regularly adjusted to take into account new data or techniques, or because of deterioration in performance. Parallel outcomes analysis, under which both the original and adjusted models' forecasts are tested against realized outcomes, provides an important test of such model adjustments. If the adjusted model does not outperform the original model, developers, users, and reviewers should realize that additional changes—or even a wholesale redesign—are likely necessary before the adjusted model replaces the original one.

Back-testing is one form of outcomes analysis; specifically, it involves the comparison of actual outcomes with model forecasts during a sample time period not used in model development and at an observation frequency that matches the forecast horizon or performance window of the model. The comparison is generally done using expected ranges or statistical confidence intervals around the model forecasts. When outcomes fall outside those intervals, the bank should analyze the discrepancies and investigate the causes that are significant in terms of magnitude or frequency. The objective of the analysis is to determine whether differences stem from the omission of material factors from the model, whether they arise from errors with regard to other aspects of model specification such as interaction terms or assumptions of linearity, or whether they are purely random and thus consistent with acceptable model performance. Analysis of in-sample fit and of model performance in holdout samples (data set aside and not used to estimate the original model) are important parts of model development but are not substitutes for back-testing.

A well-known example of back-testing is the evaluation of value-at-risk (VaR), in which actual profit and loss is compared with a model forecast loss distribution. Significant deviation in expected versus actual performance and unexplained volatility in the profits and losses of trading activities may indicate that hedging and pricing relationships are not adequately measured by a given approach. Along with measuring the frequency of losses in excess of a single VaR percentile estimator, banks should use other tests, such as assessing any clustering of exceptions and checking the distribution of losses against other estimated percentiles.

Analysis of the results of even high-quality and well-designed back-testing can pose challenges, since it is not a straightforward, mechanical process that always produces unambiguous results. The purpose is to test the model, not individual forecast values. Back-testing may entail analysis of a large number of forecasts over different conditions at a point in time or over multiple time periods. Statistical testing is essential in such cases, yet such testing can pose challenges in both the choice of appropriate tests and the interpretation of results; banks should support and document both the choice of tests and the interpretation of results.

Models with long forecast horizons should be back-tested, but given the amount of time it would take to accumulate the necessary data, that testing should be supplemented by evaluation over shorter periods. Banks should employ outcomes analysis consisting of "early warning" metrics designed to measure performance beginning very shortly after model introduction and trend analysis of performance over time. These outcomes analysis tools are not substitutes for back-testing, which should still be performed over the longer time period, but rather are very important complements.

Outcomes analysis and the other elements of the validation process may reveal significant errors or inaccuracies in model development or outcomes that consistently fall outside the bank's predetermined thresholds of acceptability. In such cases, model adjustment, recalibration, or redevelopment is warranted. Adjustments and recalibration should be governed by the principle of conservatism and should undergo independent review.

Material changes in model structure or technique, and all model redevelopment, should be subject to validation activities of appropriate range and rigor before implementation. At times, banks may have a limited ability to use key model validation tools like back-testing or sensitivity analysis for various reasons, such as lack of data or of price observability. In those cases, even more attention should be paid to the model's limitations when considering the appropriateness of model usage, and senior management should be fully informed of those limitations when using the models for decision making. Such scrutiny should be applied to individual models and models in the aggregate.

Validation of Vendor and Other Third-Party Products

The widespread use of vendor and other third-party products—including data, parameter values, and complete models—poses unique challenges for validation and other model risk-management activities because the modeling expertise is external to the user and because some components are considered proprietary. Vendor products should nevertheless be incorporated into a bank's broader model risk-management framework, following the same principles as applied to in-house models, although the process may be somewhat modified.

As a first step, banks should ensure that there are appropriate processes in place for selecting vendor models. Banks should require the vendor to provide developmental evidence explaining the product components, design, and intended use, to determine whether the model is appropriate for the bank's products, exposures, and risks. Vendors should provide appropriate testing results that show their product works as expected. They should also clearly indicate the model's limitations and assumptions and where the product's use may be problematic. Banks should expect vendors to conduct ongoing performance monitoring and outcomes analysis, with disclosure to their clients, and to make appropriate modifications and updates over time.

Banks are expected to validate their own use of vendor products. External models may not allow full access to computer coding and implementation details, so the bank may have to rely more on sensitivity analysis and benchmarking. Vendor models are often designed to provide a range of capabilities and so may need to be customized by a bank for its particular circumstances. A bank's customization choices should be documented and justified as part of validation. If vendors provide input data or assumptions, or use them to build models, their relevance for the bank's situation should be investigated. Banks should obtain information regarding the data used to develop the model and assess the extent to which that data are representative of the bank's situation. The bank also should conduct ongoing monitoring and outcomes analysis of vendor model performance using the bank's own outcomes.

Systematic procedures for validation help the bank to understand the vendor product and its capabilities, applicability, and limitations. Such detailed knowledge is necessary for basic controls of bank operations. It is also very important for the bank to have as much knowledge in-house as possible, in case the vendor or the bank terminates the contract for any reason, or if the vendor is no longer in business. Banks should have contingency plans for instances when the vendor model is no longer available or cannot be supported by the vendor.

GOVERNANCE, POLICIES, AND CONTROLS—PART VI

Developing and maintaining strong governance, policies, and controls over the model risk-management framework is fundamentally important to its effectiveness. Even if model development, implementation, use, and validation are satisfactory, a weak governance function will reduce the effectiveness of overall model risk management. A strong governance framework provides explicit support and structure to risk-management functions through policies defining relevant risk-management activities, procedures that implement those policies, allocation of resources, and mechanisms for evaluating whether policies and procedures are being carried out as specified. Notably, the extent and sophistication of a bank's governance function is expected to align with the extent and sophistication of model usage.

Board of Directors and Senior Management

Model risk governance is provided at the highest level by the board of directors and senior management when they establish a bank-wide approach to model risk management. As part of their overall responsibilities, a bank's board and senior management should establish a strong model risk-management framework that fits into the broader risk management of the organization. That framework should be grounded in an understanding of model risk—not just for individual models but also in the aggregate. The framework should include standards for model development, implementation, use, and validation.

While the board is ultimately responsible, it generally delegates to senior management the responsibility for executing and maintaining an effective model risk-management framework. Duties of senior management include establishing adequate policies and procedures and ensuring compliance, assigning competent staff, overseeing model development and implementation, evaluating model results, ensuring effective challenge, reviewing validation and internal audit findings, and taking prompt remedial action when necessary. In the same manner as for other major areas of risk, senior management, directly and through relevant committees, is responsible for regularly reporting to the board on significant model risk, from individual models and in the aggregate, and on compliance with policy. Board members should ensure that the level of model risk is within their tolerance and should direct changes where appropriate. These actions will set the tone for the whole organization about the importance of model risk and the need for active model risk management.

Policies and Procedures

Consistent with good business practices and existing supervisory expectations, banks should formalize model risk-management activities with policies and the procedures to implement them. Model risk-management policies should be consistent with this guidance and also be commensurate with the bank's relative complexity, business activities, corporate culture, and overall organizational structure. The board or its delegates should approve model risk-management policies and review them annually to ensure consistent and rigorous practices across the organization. Those policies should be updated as necessary to ensure that model risk-management practices remain appropriate and keep current with changes in market conditions, bank products and strategies, bank exposures and activities, and practices in the industry. All aspects of model risk management should be covered by suitable policies, including model and model risk definitions; assessment of model risk; acceptable practices for model development, implementation, and use; appropriate model validation activities; and governance and controls over the model risk-management process.

Policies should emphasize testing and analysis and promote the development of targets for model accuracy, standards for acceptable levels of discrepancies, and procedures for review of, and response to, unacceptable discrepancies. They should include a description of the processes used to select and retain vendor models, including the people who should be involved in such decisions.

The prioritization, scope, and frequency of validation activities should be addressed in these policies. They should establish standards for the extent of validation that should be performed before models are put into production and the scope of ongoing validation. The policies should also detail the requirements for validation of vendor models and third-party products. Finally, they should require maintenance of detailed documentation of all aspects of the model risk-management framework, including an inventory of models in use, results of the modeling and validation processes, and model issues and their resolution.

Policies should identify the roles and assign responsibilities within the model risk-management framework with clear detail on staff expertise, authority, reporting lines, and continuity. They should also outline controls on the use of external resources for validation and compliance and specify how that work will be integrated into the model risk-management framework.

Roles and Responsibilities

Conceptually, the roles in model risk management can be divided among ownership, controls, and compliance. While there are several ways in which banks can assign the responsibilities associated with these roles, it is important that reporting lines and incentives be clear, with potential conflicts of interest identified and addressed.

Business units are generally responsible for the model risk associated with their business strategies. The role of model owner involves ultimate accountability for model use and performance within the framework set by bank policies and procedures. Model owners should be responsible for ensuring that models are properly developed, implemented, and used. The model owner should also ensure that models in use have undergone appropriate validation and approval processes, promptly identify new or changed models, and provide all necessary information for validation activities.

Model risk taken by business units should be controlled. The responsibilities for risk controls may be assigned to individuals, committees, or a combination of the two, and include risk measurement, limits, and monitoring. Other responsibilities include managing the independent validation and review process to ensure that effective challenge takes place. Appropriate resources should be assigned for model validation and for guiding the scope and prioritization of work. Issues and problems identified through validation and other forms of oversight should be communicated by risk-control staff to relevant individuals and business users throughout the organization, including senior management, with a plan for corrective action. Control staff should have the authority to restrict the use of models and monitor any limits on model usage. While they may grant exceptions to typical procedures of model validation on a temporary basis, that authority should be subject to other control mechanisms, such as timelines for completing validation work and limits on model use.

Compliance with policies is an obligation of model owners and risk-control staff, and there should be specific processes in place to ensure that these roles are being carried out effectively and in line with policy. Documentation and tracking of activities surrounding model development, implementation, use, and validation are needed to provide a record that makes compliance with policy transparent.

Internal Audit

A bank's internal audit function should assess the overall effectiveness of the model risk-management framework, including the framework's ability to address both types of model risk for individual models and in the aggregate. Findings from internal audit related to models should be documented and reported to the board or its appropriately delegated agent. Banks should ensure that internal audit operates with the proper incentives, has appropriate skills, and has adequate stature in the organization to assist in model risk management. Internal audit's role is not to duplicate model risk-management activities. Instead, its role is to evaluate whether model risk management is comprehensive, rigorous, and effective. To accomplish this evaluation, internal audit staff should possess sufficient expertise in relevant modeling concepts as well as their use in particular business lines. If some internal audit staff perform certain validation activities, then they should not be involved in the assessment of the overall model risk-management framework.

Internal audit should verify that acceptable policies are in place and that model owners and control groups comply with those policies. Internal audit should also verify records of model use and validation to test whether validations are performed in a timely manner and whether models are subject to controls that appropriately account for any weaknesses in validation activities. Accuracy and completeness of the model inventory should be assessed. In addition, processes for establishing and monitoring limits on model usage should be evaluated. Internal audit should determine whether procedures for updating models are clearly documented and test whether those procedures are being carried out as specified. Internal audit should check that model owners and control groups are meeting documentation standards, including risk reporting. Additionally, internal audit should perform assessments of supporting operational systems and evaluate the reliability of data used by models.

Internal audit also has an important role in ensuring that validation work is conducted properly and that appropriate effective challenge is being carried out. It should evaluate the objectivity, competence, and organizational standing of the key validation participants, with the ultimate goal of ascertaining whether those participants have the right incentives to discover and report deficiencies. Internal audit should review validation activities conducted by internal and external parties with the same rigor to see if those activities are being conducted in accordance with this guidance.

External Resources

Although model risk management is an internal process, a bank may decide to engage external resources to help execute certain activities related to the model risk-management framework. These activities could include model validation and review, compliance functions, or other activities in support of internal audit. These resources may provide added knowledge and another level of critical and effective challenge, which may improve the internal model development and risk-management processes. However, this potential benefit should be weighed against the added costs for such resources and the added time that external parties require to understand internal data, systems, and other relevant bank-specific circumstances.

Whenever external resources are used, the bank should specify the activities to be conducted in a clearly written and agreed-upon scope of work. A designated internal party from the bank should be able to understand and evaluate the results of validation and risk-control activities conducted by external resources. The internal party is responsible for verifying that the agreed upon scope of work has been completed; evaluating and tracking identified issues and ensuring they are addressed; and making sure that completed work is incorporated into the bank's overall model risk-management framework. If the external resources are only utilized to do a portion of validation or compliance work, the bank should coordinate internal resources to complete the full range of work needed. The bank should have a contingency plan in case an external resource is no longer available or is unsatisfactory.

Model Inventory

Banks should maintain a comprehensive set of information for models implemented for use, under development for implementation, or recently retired. While each line of business may maintain its own inventory, a specific party should also be charged with maintaining a firm-wide inventory of all models, which should assist a bank in evaluating its model risk in the aggregate. Any variation of a model that warrants a separate validation should be included as a separate model and cross-referenced with other variations.

While the inventory may contain varying levels of information, given different model complexity and the bank's overall level of model usage, the following are some general guidelines. The inventory should describe the purpose and products for which the model is designed, actual or expected usage, and any restrictions on use. It is useful for the inventory to list the type and source of inputs used by a given model and underlying components (which may include other models), as well as model outputs and their intended use. It should also indicate whether models are functioning properly, provide a description of when they were last updated, and list any exceptions to policy. Other items include the names of individuals responsible for various aspects of the model development and validation; the dates of completed and planned validation activities; and the time frame during which the model is expected to remain valid.

Documentation

Without adequate documentation, model risk assessment and management will be ineffective. Documentation of model development and validation should be sufficiently detailed so that parties unfamiliar with a model can understand how the model operates, its limitations, and its key assumptions. Documentation provides for continuity of operations, makes compliance with policy transparent, and helps track recommendations, responses, and exceptions. Developers, users, control and compliance units, and supervisors are all served by effective documentation. Banks can benefit from advances in information and knowledge management systems and electronic documentation to improve the organization, timeliness, and accessibility of the various records and reports produced in the model risk-management process.

Documentation takes time and effort, and model developers and users who know the models well may not appreciate its value. Banks should therefore provide incentives to produce effective and complete model documentation. Model developers should have responsibility during model development for thorough documentation, which should be kept up-to-date as the model and application environment changes. In addition, the bank should ensure that other participants in model risk-management activities document their work, including ongoing monitoring, process verification, benchmarking, and outcomes analysis. Also, line of business or other decision makers should document information leading to selection of a given model and its subsequent validation. For cases in which a bank uses models from a vendor or other third party, it should ensure that appropriate documentation of the third-party approach is available so that the model can be appropriately validated.

Validation reports should articulate model aspects that were reviewed, highlighting potential deficiencies over a range of financial and economic conditions, and determining whether adjustments or other compensating controls are warranted. Effective validation reports include clear executive summaries, with a statement of model purpose and an accessible synopsis of model and validation results, including major limitations and key assumptions.

CONCLUSION—PART VII

Section 4027.1 provides comprehensive guidance on effective model risk management. Many of the activities described are common industry practice. But all banks should confirm that their practices conform to the principles in this guidance for model development, implementation, and use, as well as model validation. Banks should also ensure that they maintain strong governance and controls to help manage model risk, including internal policies and procedures that appropriately reflect the risk-management principles described in this guidance. Details of model risk-management practices may vary from bank to bank, as practical application of this guidance should be commensurate with a bank's risk exposures, its business activities, and the extent and complexity of its model use.

INTRODUCTION

Asset securitization typically involves the transfer of potentially illiquid on-balance-sheet assets (for example, mortgages, loans, leases) to a third party or trust. In turn, the third party or trust issues certificates or notes to investors. The cash flow from the transferred assets supports repayment of the certificates or notes. Firms use asset securitization to access alternative funding sources, manage loan concentrations, improve financial-performance ratios, and more efficiently meet customers' financing needs. Assets that are typically securitized include credit card receivables, automobile receivable paper, commercial or residential first-priority mortgages, commercial loans, home-equity loans, and student loans.

WHY FIRMS ENGAGE IN SECURITIZATION ACTIVITIES

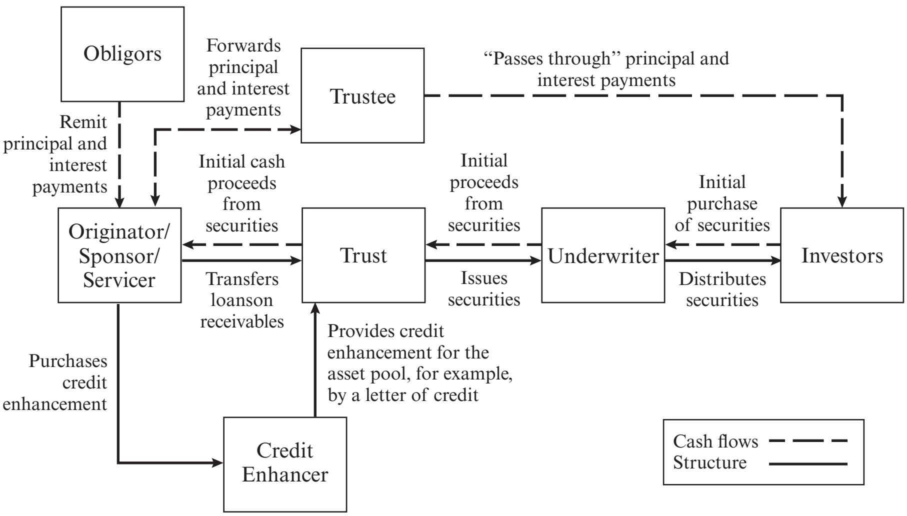
While the objectives of securitization may vary, securitized transactions may provide several benefits, such as

- transferring some of a firm's risks of ownership to parties willing and able to manage the risk;
- improving a firm's ability to manage potential asset-liability mismatches and credit concentrations;
- reducing a firm's interest-rate risk by improving the firm's asset-liability mix, especially if the firm has a large investment in fixed-rate, low-yield assets;
- transferring some on-balance-sheet assets to off-balance-sheet assets to provide some cost savings of on-balance sheet financing and enhances the firm's returns on equity and assets; or
- allowing a firm to convert its illiquid assets into a security with greater marketability that can be sold and used to diversify a firm's funding base at a potentially more favorable rate of return.

THE SECURITIZATION PROCESS

As depicted in figure 1, the asset-securitization process begins with the segregation of assets into pools that are relatively homogeneous with

Figure 1. Pass-through, asset-backed securities: structure and cash flows



respect to credit, maturity, and interest-rate risks. These pools of assets are then transferred to a trust or other entity known as "an issuer" because the entity issues the securities or ownership interests that will be acquired by investors. These asset-backed securities (ABS) may take the form of debt, certificates of beneficial ownership, or other financial instruments. The issuer is typically protected from bankruptcy through various structural and legal arrangements. A sponsor of the securitization provides the assets to be securitized (which may or may not have been originated by the sponsor) and owns or otherwise establishes the issuer.

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

The structure of the ABS also may include a guarantor that ensures that investors receive principal and interest payments on the securities on a timely basis. The guarantor agrees to make these payments to investors even if the servicer cannot collect these payments from the obligors of the underlying assets. Many issuances of mortgage-backed securities are guaranteed directly by the Government National Mortgage Association (GNMA or Ginnie Mae), which is backed by the full faith and credit of the U.S. government. Privately issued mortgage-backed securities and other types of ABS may depend on some form of credit enhancement provided by the originator of the assets or a third party to insulate the investor from some portion of, or all, credit losses. The amount of the credit enhancement may be based on several multiples of the historical losses experienced on the particular assets backing the security.

The structure of an ABS and the terms of the investors' interest(s) in the underlying assets backing the security can vary widely depending on the type of assets, the risk tolerance(s) and investment objective(s) of the investors, and the use of credit enhancements. Securitizations typically divide the credit risk of the underlying assets into different levels (sometimes called "tranches") of risk–return properties and distribute it based on the risk tolerance(s) of investors. The *first-dollar* loss, or most subordinate, position is the first to absorb credit losses, and the most senior investor position is the last to absorb losses. There also may be one or more loss positions between those tranches. Each loss position functions as a credit enhancement for the more senior positions in the structure. In other words, when ABS reallocate the risks in the underlying assets (particularly credit risk), the risks are moved into security tranches that match the desires of investors. For example, senior-subordinated security structures give holders of senior tranches greater credit-risk protection—albeit at lower yields—than holders of subordinated tranches. Under this structure, at least two classes of asset-backed securities—a senior and a junior (or subordinated) class—are issued in connection with the same pool of assets. The senior class is structured so that it has a priority claim on the cash flows from the underlying pool of assets. The subordinated class must absorb credit losses on the collateral before the senior portion experiences any losses.

TYPES OF ASSET-BACKED SECURITIES

Asset securitization involves different types of capital-market instruments. These instruments may be structured as "pass-throughs" or "pay-throughs."

Under a pass-through structure, the cash flows from the underlying pool of assets are passed through to investors on a pro rata or proportional basis. This type of security may be a single-class instrument, such as a GNMA pass-through, or a multiclass instrument, such as a real estate mortgage investment conduit.

The pay-through structure, which contains multiple classes, aggregates the cash flows from the underlying pool of assets and reallocates them to two or more issues of securities that have different cash-flow characteristics and maturities. While not particularly common, one example of a pay-through structure is the collateralized mortgage obligation (CMO), which has a series of bond classes, each with its own specified coupon and stated maturity. In most cases, the assets that make up the CMO collateral pools are pass-through securities. Scheduled principal payments and any prepayments from the underlying assets go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows from the assets would be used to retire the later bond classes. The development of the pay-through structure resulted from the desire to broaden the marketability of these securities to investors who were interested in maturities other than those generally associated with pass-through securities.

ABS backed by multiple classes of securities also may be issued as derivative instruments, such as "stripped" securities. Investors in each class of a stripped security would receive a different portion of the principal and interest cash flows from the underlying pool of assets. In their purest form, stripped securities may be issued as interest-only strips, for which the investor receives 100 percent of the interest paid on the underlying pool of assets, and as principal-only strips, for which the investor receives all of the principal paid on the underlying pool of assets. Other types of financial instruments may arise as a result of asset securitization, such as

- *Servicing assets.* These assets become a distinct asset recorded on the balance sheet of a firm when contractually separated from the assets that have been sold or securitized so that a firm retains servicing rights. In addition, servicing assets are created when a firm purchases the right to act as the servicer for the loan pool. The value of the servicing rights is based on the contractually specified servicing fees, net of servicing costs.
- *Interest-only strips receivables.* These cash flows are accounted for separately from servicing rights and reflect the right to future interest income from the serviced assets in excess of the contractually specified servicing fees.
- *ABS residuals.* These residuals (sometimes referred to as "residuals," "residual interests," or "retained interests") represent claims on any cash flows that remain after all obligations to investors of other tranches in the securitization and any related expenses have been met. The excess cash flows may arise as a result of overcollateralization or from income from reinvestment of cash. Residuals can be retained by sponsors or purchased by investors in the form of securities.

Asset-Backed Commercial Paper Programs

An asset-backed commercial paper (ABCP) program typically is a program through which a firm provides funding to its corporate customers by sponsoring and administering a bankruptcy-remote, special-purpose entity that purchases asset pools from, or extends loans to, those customers.[1] The underlying asset pools for an ABCP program might include, for example, trade receivables, consumer loans, or ABS. The ABCP program raises cash to provide funding to the firm's customers through the issuance of externally rated commercial paper into the market. The sponsoring firm often provides liquidity and credit enhancements to the ABCP program.

ABCP programs differ from some other methods of securitization in that ABCP programs typically include more than one type of asset in the underlying asset pool. Moreover, in certain cases, the cash flow from the asset pool may not necessarily match the payments to investors—the maturity of the underlying assets need not always parallel the maturity of the commercial paper liabilities of the ABCP program—since the ABCP program can engage in maturity transformation. In those instances, when the commercial paper issued by the ABCP program matures, that commercial paper usually is rolled over into, or otherwise funded by, another commercial paper issuance by the ABCP program.

For more information, see this manual's section entitled, "Overview of Asset-Backed Commercial Paper Programs."

RISKS ASSOCIATED WITH SECURITIZATION ACTIVITIES

The types of risks that firms encounter when engaging in securitization activities include credit risk, concentration risk, interest-rate risk (including prepayment risk), operational risk, and liquidity risk. Securitization activities have the potential to increase the overall risk profile of the firm if they are not carried out prudently. A firm's risk exposure will depend on the firm's role in the ABS, such as originator, servicer, credit

1. ABCP programs can include structured investment vehicles (entities that earn a spread by issuing commercial paper and medium-term notes and using the proceeds to purchase highly rated debt securities) and securities arbitrage programs.

enhancer, trustee, or investor. Potential risks can include the following:

- *Credit risk.* Firms should be aware that the credit risk involved in many securitization activities may not always be obvious. For certain types of loan securitizations, a firm may be exposed to essentially the same credit risk as in traditional lending activities, even though a particular transaction may appear to separate the firm from any risk exposure. In such cases, the firm's transfer of an asset from its balance sheet may not result in a commensurate reduction in its credit risk. Transactions that can give rise to such instances include loan sales with recourse; providing protection through credit derivatives; direct-credit substitutes, such as letters of credit; and liquidity facilities extended to securitization programs (for example, asset-securitization structures used to securitize credit card receivables).
- *Concentration risk.* A firm involved in originating, packaging, servicing, underwriting, or enhancing the creditworthiness of ABS should follow its internal diversification requirements for aggregate outstanding credits to any particular institution, industry, or geographic area.
- *Reputational risk.* The securitization activities of firms also may expose them to different levels reputational risks depending on the role that the firm in the securitization process. These firms should consider the reputational risk exposure and associated potential losses that can arise from these securitization activities. Deterioration of assets in a pool underlying a prior securitization may result in negative investor sentiment that could result in increased spreads for subsequent ABS issuances. To avoid potential increases in their funding costs, firms sometimes support their securitization transactions by improving the performance of the underlying asset pool (for example, by selling discounted receivables or adding higher-quality assets to the pool). Thus, a firm's voluntary support of its securitizations in order to protect its reputation may cause adverse effects on the sponsoring or issuing firm's earnings and capital.
- *Liquidity and market risk.* The existence of recourse provisions in asset sales, the extension of liquidity facilities to securitization programs, and early-amortization triggers of certain ABS transactions can result in significant liquidity risk to a firm serving as sponsor or issuer for the securitization. Firms engaging in these activities should ensure that their liquidity contingency plans fully incorporate the potential risk posed by their securitization activities. Upon new issuance of ABS, a firm acting as issuer should determine the potential effect on the firm's liquidity at the inception of each transaction and throughout the life of the ABS to evaluate the firm's future funding needs.
- *Transfer risk.* Transfer risk is analogous to liquidity risk. It is the risk that a firm with obligations under securitization arrangements (for example, as liquidity provider or servicer) may wish to relinquish those obligations to another party but may not be able to do so.
- *Operational risk.* This risk arises from uncertainty about a firm's ability to meet its obligations under securitization arrangements. For instance, operational risk arises when a firm has insufficient resources to meet its contractual obligations or when its fee income is insufficient to cover the costs associated with its obligations. A firm filling a role that potentially requires long-term resource commitments, such as servicer or credit enhancer, is susceptible to an operational risk.
- *Legal risk.* When a firm plays multiple roles in securitization, conflicts of interest may arise. Policies and procedures should address any potential conflict, especially any legal risk or negative market risk that may result if the firm appears to compromise any fiduciary and contractual responsibilities to obligors or investors.

ADDITIONAL RISKS ASSOCIATED WITH SECURITIZATION ACTIVITIES

Investor-Specific Risks

Investors in ABS may be exposed to varying degrees of credit risk based on the potential for obligors of the underlying assets to default on principal and interest payments. As with direct investment in the underlying assets, an investment in ABS is subject to the risk that the various parties in the securitization structure, for example, the servicer or trustee, may not be able to fulfill their contractual obligations. Moreover, ABS investors may be susceptible to concentrations of risks across various ABS investments, such as (1) overexposure to a particular firm that performs various roles in ABS securitizations, or (2) concentrations to particular geographic exposures of the underlying asset pool(s). Also, ABS investors may face heightened liquidity risk when seeking to sell ABS compared to direct holders of the underlying assets, since the secondary markets for certain ABS may be more limited than those of the underlying asset. Furthermore, certain derivative instruments, such as stripped asset-backed securities and residuals, may be extremely sensitive to interest rates and exhibit a relatively high degree of price volatility. Therefore, a firm investing in these instruments may face considerable volatility in its risk exposure unless it uses a properly structured hedging strategy.

Issuer-Specific Risks

Firms that issue ABS may feel conflicting pressures related to the assets to be transferred into pools for securitization: some may feel pressure to sell only their best assets into securitization pools, thus reducing the asset quality of their own loan portfolios, while others may feel they can relax their credit standards based on the belief that any higher-risk assets can be sold for securitization quickly, without risk to the firm's own portfolio. In addition, some issuers may face pressures to repurchase from a securitization any securities backed by loans or leases they previously originated that have deteriorated and become nonperforming in order to preserve their reputations, even if under no legal obligation to repurchase those assets (sometimes termed "moral recourse"). Issuers also may face funding risk if market conditions are not conducive to the issuance of ABS in the securitization pipeline and the firm therefore must hold the underlying assets.

Servicer-Specific Risks

Firms that service securitizations need to have policies, operations, and systems that would allow them to continue to serve as servicer without interruption and to avoid defaults. A firm can realize substantial fee income by acting as a servicer, particularly if it can leverage its fixed investment in servicing systems to achieve economies of scale. However, in seeking such scale, a firm can risk overloading its system's capacity, thereby creating enormous out-of-balance positions and cost overruns. Servicing problems may precipitate a technical default, which in turn could lead to premature redemption or accelerated repayment of the security. A firm in the role of servicer also may incur collection costs on nonperforming assets that exceed servicing fee income.

RISK MANAGEMENT OF ASSET SECURITIZATIONS

A firm should address the risks arising from its securitization activities as part of its overall risk-management system, including

- establishing clear roles for its board of directors and senior management;
- adopting appropriate policies, procedures, and processes to manage the firm's risks;
- establishing a process for measuring and monitoring risks; and
- maintaining appropriate internal controls to verify the integrity of processes associated with these activities.

For more information, see SR-99-37, "Risk Management and Valuation of Retained Interests Arising from Securitization Activities." Firms with significant securitization activities are expected to have established more elaborate and formal approaches to manage the risks associated with these activities and should ensure that risk exposures resulting from these activities are fully incorporated into relevant management information system reports and risk-management reviews.

The Roles of Senior Management and the Board of Directors

A firm's board of directors is responsible for overseeing the development of, reviewing, approving, and periodically monitoring the firm's strategy and risk appetite.[2] As such, the board of directors should have an understanding of the

2. For more information, see SR-21-3, "Supervisory Guidance on Board of Directors' Effectiveness," which generally applies to domestic bank holding companies and savings and loan holding companies with total consolidated assets of $100 billion or more.

firm's securitization activities and the associated risks. The board should approve significant policies relating to the firm's strategy and risk exposure arising from its securitization activities. The board also should hold senior management accountable for effectively implementing the firm's securitization strategy in a manner consistent with its risk appetite while maintaining an effective risk-management framework and system of internal controls.

Senior management is responsible for ensuring that the formality and sophistication of the techniques used to manage these risks are commensurate with the nature and volume of the firm's securitization activities. Senior management is responsible for ensuring that the risks arising from securitization activities are adequately managed on both a short-term and long-run basis. Management should ensure that adequate policies and procedures are in place for incorporating the risk of these activities into the firm's overall risk-management process.

Policies and Procedures

A firm's policies and procedures for asset securitization activities should ensure that the economic substance of the risk exposures generated by these activities is fully recognized and appropriately managed. In addition, firms involved in securitization activities should have appropriate policies, procedures, and controls for underwriting ABS; funding the possible return of revolving receivables (for example, credit card receivables and home-equity lines); and establishing limits on exposures to individual institutions, types of collateral, and geographic and industry concentrations.

To manage the risks associated with asset securitization activities appropriately, firms typically should—

- establish independent risk-management processes, including appropriate information systems, to monitor securitization-pool performance on an individual and aggregate transaction level;
- use conservative valuation assumptions and modeling methodologies to establish, evaluate, and adjust the carrying value of retained interests on a regular and timely basis;
- ensure staff in the audit or internal review functions periodically review data integrity, model algorithms, key underlying assumptions, and the appropriateness of the valuation and modeling process for any securitized assets retained by the institution, and report such findings to the board or an appropriate board committee;
- maintain accurate and timely risk-based capital calculations, including recognition and reporting of any recourse obligation resulting from a securitization activity;
- establish internal limits to govern the maximum amount of retained interests in any security as a percentage of total equity capital; and
- have a realistic liquidity plan in place in case of market disruptions.

Independent Risk-Management Function

Firms engaged in securitization activities should have an independent risk-management function commensurate with the complexity and volume of their securitization activity and their overall risk exposures. Considering a firm's securitization activities, the risk-management function should maintain appropriate policies and operating procedures, including clearly articulated risk limits. An effective asset-securitization policy generally—

- describes the maintenance of a consistently applied accounting methodology;
- explains the regulatory reporting requirements;
- covers valuation methodologies, including residual value assumptions, and formal procedures to approve changes to those assumptions;
- addresses management reporting process(es); and
- contains exposure limits and requirements for both individual- and aggregate-transaction monitoring.

The firm's risk-management function is responsible for monitoring origination, collection, and default-management practices. This includes regular evaluations of the quality of underwriting, soundness of the collateral valuation process, effectiveness of collection activities, ability of the default-management staff to resolve severely delinquent loans in a timely and efficient manner, and appropriateness of loss-recognition practices. Because the securitization of assets can result in current recognition of anticipated income, the risk-management function should monitor the types, volumes, and risks of assets being originated, transferred, and serviced. Senior management and the risk-management staff should be cognizant of any misaligned incentives among line managers to originate abnormally large volumes or higher-risk assets to meet income projections. Such misaligned incentives can lead to potential compromise of credit-underwriting standards, which may accelerate credit losses in future periods, impair the value of retained interests, or potentially lead to funding problems.

Risk Measurement and Monitoring

A firm's risk-management function should include systems to measure and monitor risks in a way that fully incorporates all risks involved in its securitization activities. The risk-management function should appropriately identify credit exposures from all securitization activities, and also should measure, quantify, and control those exposures on a fully consolidated basis. The economic substance of the credit exposures of securitization activities should be fully incorporated into the firm's efforts to quantify its credit risk, including efforts to establish more formal grading of credits to allow for statistical estimation of loss-probability distributions. Securitization activities should also be included in any aggregations of credit risk by borrower, industry, or economic sector.

A firm's information systems should identify and segregate those credit exposures arising from the firm's loan-sale and securitization activities. Such exposures include the sold portions of loan participations and syndications, exposures arising from the extension of credit-enhancement and liquidity facilities, the effects of any early-amortization event, and any investment(s) in ABS. Effective reports provide senior management with timely and sufficient information to monitor the firm's exposure limits and overall risk profile with respect to its securitization activities.

Stress Testing

The use of stress testing, including combinations of market events that could affect a firm's credit exposures and securitization activities, is another important element of risk management. Stress testing involves identifying possible events or changes in market behavior that could have unfavorable effects on the institution and assessing the firm's ability to withstand them. Stress testing should consider the probability of adverse events, including likely worst-case scenarios. An effective stress testing program is conducted by a firm on a consolidated basis and considers, for instance, the effect of higher-than-expected levels of delinquencies and defaults in the underlying asset pool. The firm should also consider the consequences of early-amortization events with respect to credit card securities, as these could raise concerns regarding the firm's capital adequacy and its liquidity and funding capabilities. Stress-test analyses should also include contingency plans for possible management actions in over a range of situations.

Internal Controls

One of management's most important responsibilities is establishing and maintaining an effective system of internal controls. A firm's internal controls should enforce the official lines of authority and the appropriate separation of duties established for managing the firm's risks. These internal controls should consider the type and level of risks, given the nature and scope of the firm's securitization activities. Moreover, these internal controls should ensure that financial reporting (in public financial statements and regulatory financial reports) is reliable.

Effective internal controls are essential to a firm's management of the risks associated with securitization. When properly designed and consistently enforced, a sound system of internal controls will help management safeguard the firm's resources; ensure that financial information and reports are reliable; and confirm that the firm is complying with contractual obligations, including any securitization covenants. Internal controls will also detect and reduce the possibility of significant errors and irregularities. Internal controls typically (1) limit authorities; (2) safeguard access to and use of records; (3) separate and rotate duties; and (4) ensure both regular and unscheduled reviews, including transaction testing.

Operational and managerial standards have been established for internal control and information systems.[3] A firm should maintain an appropriate system of internal controls based on the size, nature, scope, and the risk of the firm's activities.[4]

Audit Function or Internal Review

Through its risk and audit committees, an effective board of directors assesses and supports the stature and independence of the firm's independent risk management and internal audit functions. The firm's audit staff or independent-review function should be competent and fully capable of reviewing the firm's securitization activities. The audit function should perform periodic reviews of securitization activities, including transaction testing and verification, and report all findings to the board or appropriate board committee. The audit function also may assist senior management in identifying and measuring risk related to securitization activities. Principal audit targets should include compliance with securitization policies, operating and accounting procedures, securitization covenants, and the accuracy of management information systems and regulatory reports. The audit function also should confirm that the firm's regulatory reporting process is designed and managed to facilitate timely and accurate reporting. Furthermore, when a third-party services the loans underlying the securitization, the auditors should perform an independent verification of the existence of the loans to ensure that balances reconcile to internal records.

Management Information Systems

Adequate reports on the performance of assets in the ABS from management information system (MIS) can help a firm appropriately manage the amount of economic capital to cover the various risks inherent in a securitization transaction. A firm's reporting and documentation methods should support the initial valuation of any retained interests in securitized assets and provide ongoing impairment analyses of these assets. In general, effective MIS reports address the following:

- *Securitization summaries for each ABS transaction.* The summary should include relevant transaction terms, such as collateral type, liquidity facilities, maturity, credit-enhancement and subordination features, financial covenants (termination events and spread-account capture triggers), any repurchase rights or obligations, and counterparty exposures. Management should distribute transaction summaries to appropriate personnel associated with securitization activities.
- *Performance reports by portfolio and specific product type.* Performance factors include gross portfolio yield, default rates and loss severity, delinquencies, prepayments, payments, and excess spread amounts. The reports should reflect the performance of assets, both on an individual-pool basis and across total managed assets. These reports should segregate specific products issued by the firm.
- *Historical (or vintage) analysis for each pool using monthly data.* Historical analysis helps management understand past performance trends and their implications for future default rates, prepayments, and delinquencies, and therefore valuation of any retained interests. Management can use these reports to compare historical performance trends with underwriting standards, including the use of a validated credit-scoring model, to ensure loan pricing is consistent with risk levels. Historical or trend analysis also helps in the comparison of deal performance at periodic intervals and helps validate retained-interest valuation assumptions.
- *Static-pool cash-collection analysis.* A static-pool cash-collection analysis involves (1) reviewing monthly cash receipts relative to the principal balance of the pool to determine the cash yield on the portfolio, (2) comparing the cash yield to the accrual yield, and (3) tracking monthly changes. Management should compare on a monthly basis the timing and amount of cash flows received from the securitization trust with those projected as part of the retained-interest valuation analysis.

3. *See* 12 CFR 208, appendix D-1 (describing safety-and-soundness standards for state member banks).

4. Regulated financial institutions that are subject to the requirements of 12 CFR pt. 363 issued by the FDIC should include an assessment of the effectiveness of internal controls over their asset-securitization activities as part of management's report on the overall effectiveness of the system of internal controls over financial reporting. This assessment implicitly includes internal controls over financial information that the firm includes in its regulatory reporting.

Some master-trust structures allow excess cash flow to be shared between series or pools. For revolving-asset trusts with this master-trust structure, management should perform a cash-collection analysis for each master-trust structure. These analyses are critical in assessing the actual performance of the portfolio in terms of default and prepayment rates. If cash receipts are less than those assumed in the original valuation of the retained interest, this analysis will provide a firm with an early warning of possible problems with collections or extension practices and impairment of the retained interest.

- *Sensitivity analysis.* A sensitivity analysis measures a range of activities, such as the effect of changes in default rates, prepayment rates, payment rates, or discount rates, and assists management in establishing and validating the carrying value of the retained interest. Effective sensitivity analysis is performed at least quarterly. Analyses should consider potential adverse trends and determine "best," "probable," and "worst-case" scenarios for each event. Other relevant factors may include the effect of increased defaults on collection staff resources, the timing of cash flows, spread-account capture triggers, overcollateralization triggers, and early-amortization triggers. An increase in defaults can result in higher-than-expected costs and a delay in cash flows, thus decreasing the value of the retained interests. Management should periodically assess how changes in retained interests affect both the firm's earnings and its capital. Management should incorporate this analysis into their overall interest-rate-risk measurement system and include this analysis in information provided to the firm's board of directors or an appropriate board committee.
- *Statement of covenant compliance.* Ongoing compliance with deal-performance triggers as defined by the pooling and servicing agreements should be affirmed at least monthly. Performance triggers include early amortization, spread capture, changes to overcollateralization requirements, and events that could result in the firm being removed as servicer.

A firm must not include confidential supervisory information related to supervisory actions or thresholds in any covenants included in documents related to a securitization transaction.[5] Examples of such supervisory actions include a downgrade in a bank's CAMELS rating, an enforcement action, or a downgrade in a bank's prompt-corrective-action capital category. Further, covenants that provide for the early termination of the transaction or compel the transfer of servicing due, directly or indirectly, to the occurrence of a supervisory action or event will be criticized, under appropriate circumstances, as an unsafe and unsound banking practice.[6] Any early amortization or transfer of servicing triggered by such events can create or exacerbate liquidity and earnings problems for a firm, which in turn may lead to further deterioration in its financial condition.

CAPITAL ADEQUACY

The Federal Reserve's Regulation Q (12 CFR pt. 217) establishes a capital framework that considers the credit risk of exposures that involve the tranching of credit risk of one or more underlying securitization exposures. Regulation Q establishes risk weights for securitization exposures that are retained on- or off-balance sheet. 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 such a securitization exposure.

Common examples of securitization exposures include private-label CMOs, trust-preferred collateralized debt obligations, and ABS, provided there is tranching of credit risk. In general, supervised institutions subject to Regulation Q's requirements calculate the risk weight of securitization exposures using methodologies prescribed in the rule, such as the gross-up approach or the Simplified Supervisory Formula Approach. The methodology must be applied consistently across all securitization exposures, except in certain cases.

For more information, see this manual's section entitled "Assessment of Capital Adequacy."

5. For more information on the treatment of confidential supervisory information, see 12 U.S.C. 1817(a) and 1831m, as well as 12 CFR 261 subpart C.

6. *See* SR-02-14, "Covenants in Securitization Documents Linked to Supervisory Actions or Thresholds."

ACCOUNTING AND REPORTING

Sale or Borrowing Treatment

Asset-securitization transactions are frequently structured to obtain certain accounting treatments, which in turn affect the firm's reported measures of profitability and capital adequacy. In transferring assets into a pool to serve as collateral for ABS, a key question is whether the transfer should be treated as a sale of the assets or as a collateralized borrowing (meaning a financing transaction secured by assets).

When a loan is acquired (through origination or purchase) with the intent or expectation that it may or will be sold at some indefinite date in the future, the loan should be reported as held for sale or held for investment, based on consideration of all the facts and circumstances, in accordance with generally accepted accounting principles (GAAP) and related supervisory guidance. In addition, a loan acquired and held for securitization purposes should be reported as a loan held for sale, provided the securitization transaction will be accounted for as a sale under Accounting Standards Codification (ASC) Topic 860, Transfers and Servicing. Notwithstanding the above, banks may classify loans as trading assets if the bank applies fair value accounting, with changes in fair value reported in current earnings, and manages these assets and liabilities as trading assets, subject to the controls and applicable regulatory guidance related to trading activities. For example, a bank generally would not classify a loan that meets these criteria as a trading asset unless the bank holds the loan for one of the following purposes: (a) to facilitate market making activities, including such activities as accumulating loans for sale or securitization; (b) to benefit from actual or expected price movements; or (c) to lock in arbitrage profits.

Institutions that file the Report of Condition and Income (Call Report) and are involved in securitization activities should pay particular attention to the following schedules on the Call Report: Schedule RC-F: Other Assets; Schedule RC-L: Off Balance Sheet Items; and Schedule RC-R: Regulatory Capital.

Valuation and Modeling Processes for Retained Interests

The methodologies and models firms use to value retained interests and the difficulties in managing exposure to these volatile assets can raise supervisory concerns. Under GAAP, a firm recognizes an immediate gain (or loss) on the sale of assets by recording its retained interest at fair value. The valuation of the retained interest is based on the present value of future cash flows in excess of the amounts needed to service the securities and to cover credit losses and other fees of the securitization vehicle.

Determinations of fair value should be based on reasonable, conservative assumptions about factors, such as discount rates, projected credit losses, and prepayment rates. Bank supervisors expect retained interests to be supported by verifiable documentation of fair value in accordance with GAAP. In the absence of such support, the retained interests should not be carried as assets on an institution's books but should be charged off. Other supervisory concerns include failure to recognize and to hold sufficient capital against recourse obligations generated by securitizations and absence of an adequate and independent audit function.

The methodology and key assumptions used to value the retained interests and servicing assets or liabilities must be reasonable and fully documented. The key assumptions in all valuation analyses include prepayment rates, payment rates, default rates, loss-severity factors, and discount rates. Institutions are expected to take a logical and conservative approach when developing securitization assumptions and capitalizing future income flows. It is important that management quantifies the assumptions at least quarterly on a pool-by-pool basis and maintains supporting documentation for all changes to the assumptions as part of the valuation. Policies should define the acceptable reasons for changing assumptions and require appropriate management approval.

An exception to this pool-by-pool valuation analysis may be applied to revolving-asset trusts if the master-trust structure allows excess cash flows to be shared between series. In a master trust, each certificate of each series represents an undivided interest in all of the receivables in the trust. Therefore, valuations are appropriate at the master-trust level.

To determine the value of the retained interest at inception, and to make appropriate adjustments going forward, the institution should implement a reasonable modeling process to comply with ASC Topic 860. Management is expected to employ reasonable and conservative valuation assumptions and projections and to maintain verifiable objective documentation of the fair value of the retained interest. Senior management is responsible for ensuring that the valuation model accurately reflects the cash flows according to the terms of the securitization's structure. For example, the model should account for any cash collateral or overcollateralization triggers, trust fees, and insurance payments, as appropriate. Management is accountable for ensuring that the model builder(s) possess the necessary expertise and technical proficiency to perform the modeling process. Senior management should ensure that internal controls are in place to provide for the ongoing integrity of MIS associated with securitization activities.

As part of the modeling process, the risk-management function should ensure that periodic validations are performed to reduce vulnerability to model risk. Validation of the model includes testing the internal logic, ensuring empirical support for the model assumptions, and back-testing the models using actual cash flows on a pool-by-pool basis. The validation process should be documented to support conclusions. Senior management should ensure that the validation process is independent from line management and from the modeling process. The audit scope should include procedures to ensure that the modeling process and validation mechanisms are both appropriate for the institution's circumstances and executed consistently with its asset-securitization policy.

Use of Outside Parties

Third parties are often engaged to provide professional guidance and support regarding a firm's securitization activities and transactions as well as valuation of retained interests. The use of outside resources does not relieve a board of directors of its oversight responsibility, nor does it relieve senior management of its responsibilities to provide supervision, monitoring, and oversight of securitization activities, particularly management of the risks associated with retained interests. Management is expected to have the experience, knowledge, and abilities to discharge its duties; to understand the nature and extent of the risks presented by retained interests; and to have the policies and procedures necessary to implement an effective risk-management system to control such risks. Management should have an understanding of the valuation techniques used to determine the value of the firm's interest in a securitization, including the basis and reasonableness of underlying assumptions and projections.

Market Discipline and Disclosures

Transparency through public disclosure is crucial to effective market discipline and can reinforce supervisory expectations for a firm's risk management. Timely and adequate information on a firm's asset-securitization activities should be disclosed. The information in the firm's public disclosures should be comprehensive; however, the amount of disclosure that is appropriate will depend on the volume of securitizations and the complexity of the firm's securitization activities. Well informed investors, depositors, creditors, and other counterparties can provide a firm with strong incentives for maintaining sound risk-management systems and internal controls.

Adequate disclosure allows market participants to understand a firm's financial condition and apply market discipline, thus creating incentives to reduce inappropriate risk-taking or to address inadequate risk-management practices. Examples of sound disclosures include—

- accounting policies for measuring retained interests, including a discussion of the implications of key assumptions on the recorded value of the firm's interest in the securitization(s);
- the process and methodology used to adjust the value of retained interests for changes in key assumptions;
- quantitative and qualitative risk characteristics of the underlying securitized assets;
- the role of retained interests as credit enhancements to special-purpose entities and other securitization vehicles, including a discussion of techniques used for measuring credit risk; and
- sensitivity analyses conducted by the firm to understand the effect of changes in key

assumptions on the fair value of retained interests.

SUPERVISORY CONSIDERATIONS

Examiners are expected to exercise judgment in determining which examination procedures are appropriate for assessing the securitization activities of an individual bank. The scope of each review will largely depend on the size and complexity of a bank's securitization activities as well as the ability of the bank to manage the risks associated with these activities appropriately. The Securitization Examination Documentation (ED) module provides more detailed examination procedures for examination staff. The Securitization ED module primarily applies to examinations of banks that use securitizations to transfer financial assets off their balance sheets. The ED Module also applies to the review of banks that originate or purchase financial assets for securitization; retain beneficial interests in securitized assets; or provide liquidity or credit enhancements.

As previously noted, securitization activities have the potential to increase the overall risk profile of the bank if the activities are not carried out prudently. Banks that engage in securitization activities encounter various risks, such as credit, concentration, interest-rate, operational, and liquidity risks. The nature of a bank's securitization activities and the bank's ability to manage those activities will influence how examiners assign supervisory ratings, particularly a bank's CAMELS component or composite ratings.

For example, examiners should determine whether the bank has sufficient capital in relation to risks arising from securitization activities. If, in the examiner's judgment, a bank's capital level is not sufficient to provide protection against potential losses from securitization activities, this deficiency should be reflected in the bank's CAMELS rating and discussed with bank management. In such situations, examiners would expect that the bank would develop and implement a plan for strengthening its overall capital adequacy to levels deemed appropriate given its risk exposure.

Asset securitization activities can adversely influence how examiners rate a bank's asset quality in several ways. A bank that originates abnormally large volumes or higher-risk assets to sustain ongoing income needs potentially may compromise its credit-underwriting standards. The result could be an acceleration of credit losses in future periods. Further, a bank could be exposed to concentration risk if its securitized assets contain excessive exposures to an industry or region.

In terms of the assessment of liquidity, one factor examiners should consider is a bank's ability to securitize and sell certain pools of assets.[7] While securitization can be an effective funding method for some banks, there are several risks.[8] For instance, banks that originate or purchase loans for asset securitization programs may face heightened liquidity risk due to unexpected funding needs associated with an early amortization event or disruption of warehouse funding. Furthermore, the bank's overall cash flow might be dependent on the residual cash flows from the performance of the underlying assets. If the performance of the underlying assets is worse than projected, the bank's overall cash flow will be less than anticipated, which would adversely affect the bank's liquidity. Examiners should determine whether a bank has reviewed the projected cash flow from the underlying assets to ensure that principal and interest payments will be timely and will be sufficient to cover costs even under adverse scenarios.

Securitization activities could affect the way examiners assess the sensitivity to market risk component rating of the CAMELS rating system. Examiners should assess whether banks engaged in underwriting or market-making activities have implemented adequate hedging or other risk-management policies to limit exposure to adverse price movements. For instance, banks should appropriately manage changes in default rates, prepayment rates, payment rates, and discount rates when establishing and validating the carrying value of any retained interest(s). Examiners should review a bank's analysis as well as the volatility associated with retained interests when assessing a bank's sensitivity to market risk component rating.[9]

Further, the ability of banks to appropriately manage and monitor the risks associated with

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7. SR-96-38, "Uniform Financial Institutions Rating System."

8. SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management."

9. SR-96-13, "Joint Agency Policy Statement on Interest-Rate Risk," advises that examiners may direct institutions with a high level of exposure to interest-rate risk relative to capital to take corrective action.

securitization activities will influence examiners' assessment of a bank's management rating. For example, if bank management conducts securitization activities in a manner that is inconsistent with the bank's strategic and financial objectives, such conduct may adversely affect the bank's management rating. The management rating could also be adversely affected if a bank exhibits internal control failures or is not appropriately responsive to findings arising from internal audits, independent reviews, or previous supervisory assessments of the bank's securitization function.

Asset Securitization
Examination Procedures
Effective date May 2022

Section 4030.3

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Securitization

This section sets forth the Interagency Statement on Sound Practices Concerning Elevated-Risk Complex Structured Finance Activities, issued January 11, 2007.[1] The supervisory guidance addresses risk-management principles that should assist institutions to identify, evaluate, and manage the heightened legal and reputational risks that may arise from their involvement in complex structured finance transactions (CSFTs). The guidance is focused on sound practices related to CSFTs that may create heightened legal or reputational risks to the institution and are defined as "elevated-risk CSFTs." Such transactions are typically conducted by a limited number of large financial institutions.[2] (See SR-07-05.)

INTERAGENCY STATEMENT ON SOUND PRACTICES CONCERNING ELEVATED-RISK COMPLEX STRUCTURED FINANCE ACTIVITIES

Financial markets have grown rapidly over the past decade, and innovations in financial instruments have facilitated the structuring of cash flows and allocation of risk among creditors, borrowers, and investors in more efficient ways. Financial derivatives for market and credit risk, asset-backed securities with customized cash-flow features, specialized financial conduits that manage pools of assets, and other types of structured finance transactions serve important business purposes, such as diversifying risks, allocating cash flows, and reducing cost of capital. As a result, structured finance transactions have become an essential part of U.S. and international capital markets. Financial institutions have played and continue to play an active and important role in the development of structured finance products and markets, including the market for the more complex variations of structured finance products.

When a financial institution[3] participates in a CSFT, it bears the usual market, credit, and operational risks associated with the transaction. In some circumstances, a financial institution also may face heightened legal or reputational risks due to its involvement in a CSFT. For example, in some circumstances, a financial institution may face heightened legal or reputational risk if a customer's regulatory, tax, or accounting treatment for a CSFT, or disclosures to investors concerning the CSFT in the customer's public filings or financial statements, do not comply with applicable laws, regulations, or accounting principles. Indeed, in some instances, CSFTs have been used to misrepresent a customer's financial condition to investors, regulatory authorities, and others. In these situations, investors have been harmed and financial institutions have incurred significant legal and reputational exposure. In addition to legal risk, reputational risk poses a significant threat to financial institutions because the nature of their business requires them to maintain the confidence of customers, creditors, and the general marketplace.

The agencies[4] have long expected financial institutions to develop and maintain robust control infrastructures that enable them to identify, evaluate, and address the risks associated with their business activities. Financial institutions also must conduct their activities in accordance with applicable statutes and regulations.

Scope and Purpose of Statement

The agencies issued this statement to describe the types of risk-management principles they believe may help a financial institution to identify CSFTs that may pose heightened legal or reputational risks to the institution and to evalu-

1. See 72 *Fed. Reg.* 1372, January 11, 2007.
2. The statement will not affect or apply to the vast majority of financial institutions, including most small institutions.
3. As used in this statement, the term *financial institution* or *institution* refers to state member banks and bank holding companies (other than foreign banking organizations) in the case of the Board of Governors of the Federal Reserve System (FRB); to national banks in the case of the Office of the Comptroller of the Currency (OCC); to federal and state savings associations and savings and loan holding companies in the case of the Office of Thrift Supervision (OTS); to state nonmember banks in the case of the Federal Deposit Insurance Corporation (FDIC); and to registered broker-dealers and investment advisers in the case of the Securities and Exchange Commission (SEC). The U.S. branches and agencies of foreign banks supervised by the FRB, the OCC, and the FDIC also are considered to be financial institutions for purposes of this statement.
4. The federal banking agencies (the FRB, the OCC, the FDIC, and the OTS) and the SEC.

ate, manage, and address these risks within the institution's internal control framework.

Structured finance transactions encompass a broad array of products with varying levels of complexity. Most structured finance transactions, such as standard public mortgage-backed securities transactions, public securitizations of retail credit cards, asset-backed commercial paper conduit transactions, and hedging-type transactions involving "plain vanilla" derivatives and collateralized loan obligations, are familiar to participants in the financial markets, and these vehicles have a well-established track record. These transactions typically would not be considered CSFTs for the purpose of this statement.

Because this statement focuses on sound practices related to CSFTs that may create heightened legal or reputational risks—transactions that typically are conducted by a limited number of large financial institutions—it will not affect or apply to the vast majority of financial institutions, including most small institutions. As in all cases, a financial institution should tailor its internal controls so that they are appropriate in light of the nature, scope, complexity, and risks of its activities. Thus, for example, an institution that is actively involved in structuring and offering CSFTs that may create heightened legal or reputational risk for the institution should have a more formalized and detailed control framework than an institution that participates in these types of transactions less frequently. The internal controls and procedures discussed in this statement are not all-inclusive, and, in appropriate circumstances, an institution may find that other controls, policies, or procedures are appropriate in light of its particular CSFT activities.

Because many of the core elements of an effective control infrastructure are the same regardless of the business line involved, this statement draws heavily on controls and procedures that the agencies previously have found to be effective in assisting a financial institution to manage and control risks and identifies ways in which these controls and procedures can be effectively applied to elevated-risk CSFTs. Although this statement highlights some of the most significant risks associated with elevated-risk CSFTs, it is not intended to present a full exposition of all risks associated with these transactions. Financial institutions are encouraged to refer to other supervisory guidance prepared by the agencies for further information concerning market, credit, operational, legal, and reputational risks as well as internal audit and other appropriate internal controls.

This statement does not create any private rights of action and does not alter or expand the legal duties and obligations that a financial institution may have to a customer, its shareholders, or other third parties under applicable law. At the same time, adherence to the principles discussed in this statement would not necessarily insulate a financial institution from regulatory action or any liability the institution may have to third parties under applicable law.

Identification and Review of Elevated-Risk CSFTs

A financial institution that engages in CSFTs should maintain a set of formal, written, firm-wide policies and procedures that are designed to allow the institution to identify, evaluate, assess, document, and control the full range of credit, market, operational, legal, and reputational risks associated with these transactions. These policies may be developed specifically for CSFTs, or included in the set of broader policies governing the institution generally. A financial institution operating in foreign jurisdictions may tailor its policies and procedures as appropriate to account for, and comply with, the applicable laws, regulations, and standards of those jurisdictions.[5]

A financial institution's policies and procedures should establish a clear framework for the review and approval of individual CSFTs. These policies and procedures should set forth the responsibilities of the personnel involved in the origination, structuring, trading, review, approval, documentation, verification, and execution of CSFTs. Financial institutions may find it helpful to incorporate the review of new CSFTs into their existing new-product policies. In this regard, a financial institution should define what constitutes a "new" complex structured finance product and establish a control process for the approval of such new products. In determining

5. In the case of U.S. branches and agencies of foreign banks, these policies, including management, review, and approval requirements, should be coordinated with the foreign bank's group-wide policies developed in accordance with the rules of the foreign bank's home-country supervisor and should be consistent with the foreign bank's overall corporate and management structure as well as its framework for risk management and internal controls.

whether a CSFT is new, a financial institution may consider a variety of factors, including whether it contains structural or pricing variations from existing products; whether the product is targeted at a new class of customers; whether it is designed to address a new need of customers; whether it raises significant new legal, compliance, or regulatory issues; and whether it or the manner in which it would be offered would materially deviate from standard market practices. An institution's policies should require new complex structured finance products to receive the approval of all relevant control areas that are independent of the profit center before the product is offered to customers.

Identifying Elevated-Risk CSFTs

As part of its transaction and new-product approval controls, a financial institution should establish and maintain policies, procedures, and systems to identify elevated-risk CSFTs. Because of the potential risks they present to the institution, transactions or new products identified as elevated-risk CSFTs should be subject to heightened reviews during the institution's transaction or new-product approval processes. Examples of transactions that an institution may determine warrant this additional scrutiny are those that (either individually or collectively) appear to the institution during the ordinary course of its transaction approval or new-product approval process to—

- lack economic substance or business purpose;
- be designed or used primarily for questionable accounting, regulatory, or tax objectives, particularly when the transactions are executed at year-end or at the end of a reporting period for the customer;
- raise concerns that the client will report or disclose the transaction in its public filings or financial statements in a manner that is materially misleading or inconsistent with the substance of the transaction or applicable regulatory or accounting requirements;
- involve circular transfers of risk (either between the financial institution and the customer or between the customer and other related parties) that lack economic substance or business purpose;
- involve oral or undocumented agreements that, when taken into account, would have a material impact on the regulatory, tax, or accounting treatment of the related transaction, or the client's disclosure obligations;[6]
- have material economic terms that are inconsistent with market norms (for example, deep "in the money" options or historic rate rollovers); or
- provide the financial institution with compensation that appears substantially disproportionate to the services provided or investment made by the financial institution or to the credit, market, or operational risk assumed by the institution.

The examples listed previously are provided for illustrative purposes only, and the policies and procedures established by financial institutions may differ in how they seek to identify elevated-risk CSFTs. The goal of each institution's policies and procedures, however, should remain the same: to identify those CSFTs that warrant additional scrutiny in the transaction or new-product approval process due to concerns regarding legal or reputational risks.

Financial institutions that structure or market, act as an advisor to a customer regarding, or otherwise play a substantial role in a transaction may have more information concerning the customer's business purpose for the transaction and any special accounting, tax, or financial disclosure issues raised by the transaction than institutions that play a more limited role. Thus, the ability of a financial institution to identify the risks associated with an elevated-risk CSFT may differ depending on its role.

Due Diligence, Approval, and Documentation Process for Elevated-Risk CSFTs

Having developed a process to identify elevated-risk CSFTs, a financial institution should implement policies and procedures to conduct a heightened level of due diligence for these transactions. The financial institution should design these policies and procedures to allow personnel at an appropriate level to understand and evaluate the potential legal or reputational risks presented by

6. This item is not intended to include traditional, nonbinding "comfort" letters or assurances provided to financial institutions in the loan process where, for example, the parent of a loan customer states that the customer (i.e., the parent's subsidiary) is an integral and important part of the parent's operations.

the transaction to the institution and to manage and address any heightened legal or reputational risks ultimately found to exist with the transaction.

Due diligence. If a CSFT is identified as an elevated-risk CSFT, the institution should carefully evaluate and take appropriate steps to address the risks presented by the transaction, with a particular focus on those issues identified as potentially creating heightened levels of legal or reputational risk for the institution. In general, a financial institution should conduct the level and amount of due diligence for an elevated-risk CSFT that is commensurate with the level of risks identified. A financial institution that structures or markets an elevated-risk CSFT to a customer, or that acts as an advisor to a customer or investors concerning an elevated-risk CSFT, may have additional responsibilities under the federal securities laws, the Internal Revenue Code, state fiduciary laws, or other laws or regulations and, thus, may have greater legal- and reputational-risk exposure with respect to an elevated-risk CSFT than a financial institution that acts only as a counterparty for the transaction. Accordingly, a financial institution may need to exercise a higher degree of care in conducting its due diligence when the institution structures or markets an elevated-risk CSFT or acts as an advisor concerning such a transaction than when the institution plays a more limited role in the transaction.

To appropriately understand and evaluate the potential legal and reputational risks associated with an elevated-risk CSFT that a financial institution has identified, the institution may find it useful or necessary to obtain additional information from the customer or to obtain specialized advice from qualified in-house or outside accounting, tax, legal, or other professionals. As with any transaction, an institution should obtain satisfactory responses to its material questions and concerns prior to consummation of a transaction.[7]

In conducting its due diligence for an elevated-risk CSFT, a financial institution should independently analyze the potential risks to the institution from both the transaction and the institution's overall relationship with the customer. Institutions should not conclude that a transaction identified as being an elevated-risk CSFT involves minimal or manageable risks solely because another financial institution will participate in the transaction or because of the size or sophistication of the customer or counterparty. Moreover, a financial institution should carefully consider whether it would be appropriate to rely on opinions or analyses prepared by or for the customer concerning any significant accounting, tax, or legal issues associated with an elevated-risk CSFT.

Approval process. A financial institution's policies and procedures should provide that CSFTs identified as having elevated legal or reputational risk are reviewed and approved by appropriate levels of control and management personnel. The designated approval process for such CSFTs should include representatives from the relevant business line(s) and/or client management, as well as from appropriate control areas that are independent of the business line(s) involved in the transaction. The personnel responsible for approving an elevated-risk CSFT on behalf of a financial institution should have sufficient experience, training, and stature within the organization to evaluate the legal and reputational risks, as well as the credit, market, and operational risks to the institution.

The institution's control framework should have procedures to deliver the necessary or appropriate information to the personnel responsible for reviewing or approving an elevated-risk CSFT to allow them to properly perform their duties. Such information may include, for example, the material terms of the transaction, a summary of the institution's relationship with the customer, and a discussion of the significant legal, reputational, credit, market, and operational risks presented by the transaction.

Some institutions have established a senior management committee that is designed to involve experienced business executives and senior representatives from all of the relevant control functions within the financial institution (including such groups as independent risk management, tax, accounting, policy, legal, compliance, and financial control) in the oversight and approval of those elevated-risk CSFTs that are identified by the institution's personnel as requiring senior management review and approval due to the potential risks associated with the transactions. While this type of management committee may not be appropriate for all financial institutions, a financial institution should establish processes that assist the institution in con-

7. Of course, financial institutions also should ensure that their own accounting for transactions complies with applicable accounting standards, consistently applied.

sistently managing the review and approval of elevated-risk CSFTs on a firm-wide basis.[8]

If, after evaluating an elevated-risk CSFT, the financial institution determines that its participation in the CSFT would create significant legal or reputational risks for the institution, the institution should take appropriate steps to address those risks. Such actions may include declining to participate in the transaction, or conditioning its participation upon the receipt of representations or assurances from the customer that reasonably address the heightened legal or reputational risks presented by the transaction. Any representations or assurances provided by a customer should be obtained before a transaction is executed and be received from, or approved by, an appropriate level of the customer's management. A financial institution should decline to participate in an elevated-risk CSFT if, after conducting appropriate due diligence and taking appropriate steps to address the risks from the transaction, the institution determines that the transaction presents unacceptable risk to the institution or would result in a violation of applicable laws, regulations, or accounting principles.

Documentation. The documentation that financial institutions use to support CSFTs is often highly customized for individual transactions and negotiated with the customer. Careful generation, collection, and retention of documents associated with elevated-risk CSFTs are important control mechanisms that may help an institution monitor and manage the legal, reputational, operational, market, and credit risks associated with the transactions. In addition, sound documentation practices may help reduce unwarranted exposure to the financial institution's reputation.

A financial institution should create and collect sufficient documentation to allow the institution to—

- document the material terms of the transaction;
- enforce the material obligations of the counterparties;
- confirm that the institution has provided the customer any disclosures concerning the transaction that the institution is otherwise required to provide; and
- verify that the institution's policies and procedures are being followed and allow the internal audit function to monitor compliance with those policies and procedures.

When an institution's policies and procedures require an elevated-risk CSFT to be submitted for approval to senior management, the institution should maintain the transaction-related documentation provided to senior management as well as other documentation, such as minutes of the relevant senior management committee, that reflect senior management's approval (or disapproval) of the transaction, any conditions imposed by senior management, and the factors considered in taking such action. The institution should retain documents created for elevated-risk CSFTs in accordance with its record retention policies and procedures as well as applicable statutes and regulations.

Other Risk-Management Principles for Elevated-Risk CSFTs

General business ethics. The board and senior management of a financial institution also should establish a "tone at the top" through both actions and formalized policies that sends a strong message throughout the financial institution about the importance of compliance with the law and overall good business ethics. The board and senior management should strive to create a firm-wide corporate culture that is sensitive to ethical or legal issues as well as the potential risks to the financial institution that may arise from unethical or illegal behavior. This kind of culture coupled with appropriate procedures should reinforce business-line ownership of risk identification and encourage personnel to move ethical or legal concerns regarding elevated-risk CSFTs to appropriate levels of management. In appropriate circumstances, financial institutions may also need to consider implementing mechanisms to protect personnel by permitting the confidential disclosure of concerns.[9] As in other areas of financial institution management, compensation and incentive plans

8. The control processes that a financial institution establishes for CSFTs should take account of, and be consistent with, any informational barriers established by the institution to manage potential conflicts of interest, insider trading, or other concerns.

9. The agencies note that the Sarbanes-Oxley Act of 2002 requires companies listed on a national securities exchange or inter-dealer quotation system of a national securities association to establish procedures that enable employees to submit concerns regarding questionable accounting or auditing mat-

should be structured, in the context of elevated-risk CSFTs, so that they provide personnel with appropriate incentives to have due regard for the legal-, ethical-, and reputational-risk interests of the institution.

Reporting. A financial institution's policies and procedures should provide for the appropriate levels of management and the board of directors to receive sufficient information and reports concerning the institution's elevated-risk CSFTs to perform their oversight functions.

Monitoring compliance with internal policies and procedures. The events of recent years evidence the need for an effective oversight and review program for elevated-risk CSFTs. A financial institution's program should provide for periodic independent reviews of its CSFT activities to verify and monitor that its policies and controls relating to elevated-risk CSFTs are being implemented effectively and that elevated-risk CSFTs are accurately identified and have received proper approvals. These independent reviews should be performed by appropriately qualified audit, compliance, or other personnel in a manner consistent with the institution's overall framework for compliance monitoring, which should include consideration of issues such as the independence of reviewing personnel from the business line. Such monitoring may include more-frequent assessments of the risk arising from elevated-risk CSFTs, both individually and within the context of the overall customer relationship, and the results of this monitoring should be provided to an appropriate level of management in the financial institution.

Audit. The internal audit department of any financial institution is integral to its defense against fraud, unauthorized risk taking, and damage to the financial institution's reputation. The internal audit department of a financial institution should regularly audit the financial institution's adherence to its own control procedures relating to elevated-risk CSFTs, and further assess the adequacy of its policies and procedures related to elevated-risk CSFTs. Internal audit should periodically validate that business lines and individual employees are complying with the financial institution's standards for elevated-risk CSFTs and appropriately identifying any exceptions. This validation should include transaction testing for elevated-risk CSFTs.

Training. An institution should identify relevant personnel who may need specialized training regarding CSFTs to be able to effectively perform their oversight and review responsibilities. Appropriate training on the financial institution's policies and procedures for handling elevated-risk CSFTs is critical. Financial institution personnel involved in CSFTs should be familiar with the institution's policies and procedures concerning elevated-risk CSFTs, including the processes established by the institution for identification and approval of elevated-risk CSFTs and new complex structured finance products and for the elevation of concerns regarding transactions or products to appropriate levels of management. Financial institution personnel involved in CSFTs should be trained to identify and properly handle elevated-risk CSFTs that may result in a violation of law.

CONCLUSION

Structured finance products have become an essential and important part of the U.S. and international capital markets, and financial institutions have played an important role in the development of structured finance markets. In some instances, however, CSFTs have been used to misrepresent a customer's financial condition to investors and others, and financial institutions involved in these transactions have sustained significant legal and reputational harm. In light of the potential legal and reputational risks associated with CSFTs, a financial institution should have effective risk-management and internal control systems that are designed to allow the institution to identify elevated-risk CSFTs; to evaluate, manage, and address the risks arising from such transactions; and to conduct those activities in compliance with applicable law.

ters on a confidential, anonymous basis. (See 15 USC 78j-1(m).)

Bank management is responsible for controlling risk at a level deemed acceptable for the organization. An effective risk-management program begins with the identification of exposures that could disrupt the timely and accurate delivery of business services or result in unexpected financial claims on bank resources. Risk management also involves the implementation of cost-effective controls and the shifting, transfer, or assignment of risk to third parties through insurance coverage or other risk-transfer techniques. Although the design and sophistication of risk-management procedures varies from bank to bank, each institution's decision-making process should effectively identify; control; and, when or where appropriate, result in some transfer of risk. The risk-assessment program should be conducted annually to establish whether potential service disruptions and estimated risk-related financial costs and losses can be contained at levels deemed acceptable to bank management and the board of directors. Note that insurance can provide a bank with the resources to restore business operations and financial stability only *after* an unanticipated event has occurred, but a bank's own risk-management controls can prevent and minimize losses before they occur.

RISK-MANAGEMENT PROGRAM

A sound operational risk-management program requires the annual review of all existing business operations and a risk assessment of all proposed services. Identified risks should be analyzed to estimate their potential and probable levels of loss exposure. While the historical loss experience of the bank and other service providers may be helpful in quantifying loss exposure, technological and societal changes may result in exposure levels that differ from historical experience. Nevertheless, current exposure estimates should be derived from the bank's historical loss experience and augmented with industry experience. In addition, the bank's insurance broker or agent should be a source of advice.

Management must decide the most appropriate method for addressing a particular risk. Although many factors influence this decision, the purpose of risk management is to minimize the probability of losses and the net costs associated with them. In that context, cost is broadly defined to include—

- the direct and consequential cost of loss-prevention measures (controls), plus
- insurance premiums, plus
- losses sustained, including the consequential effects and expenses to reduce such losses, minus
- recoveries from third parties and indemnities from insurers on account of such losses, plus
- pertinent administrative costs.

Bank risks with potentially high or even catastrophic financial consequences should be eliminated or substantially mitigated whenever possible, even when the risk's frequency of occurrence is low. These risks can be eliminated by discontinuing operations where appropriate or by assigning the risk exposure to other parties using third-party service providers. When the exposure cannot be shifted to other parties or otherwise mitigated, the bank must protect itself with appropriate levels of insurance. Certain loss exposures may be deemed reasonable because their probability of frequency and severity of loss are low, the level of expected financial loss or service disruption is minimal, or the costs associated with the recovery of assets and restoration of services are low.

Bank management may decide to reduce insurance premiums and claims-processing costs by self-insuring for various types of losses, setting higher deductible levels, lowering the coverage limits for insurance purchased, and narrowing coverage terms and conditions. A financial organization's primary defenses against loss are adequate internal controls and procedures, which insurance is intended to complement, not replace. Thus, an overall appraisal of the organization's control environment is a significant consideration in determining the adequacy of the insurance program. To the extent that controls are lacking, the need for additional insurance coverage increases. These determinations should be based on the results of the risk assessment and be consistent with the limits established by the board of directors. Insurance decisions may also be influenced by the insurance broker's advice regarding current insurance market and premium trends.

Following September 2001, insurance companies reevaluated their position on providing coverage for acts of terrorism. As a result, terrorism coverage has become expensive or unavailable. The bank's "schedule of insurance" should note which policies contain exclusions, sublimits, or large deductibles for losses incurred as a result of terrorism.

When selecting insurance carriers, banks should consider the financial strength and claims-paying capacity of the insurance underwriter, as well as the robustness or strength of the supervisory regime to which the insurer is subject. This procedure is important for all significant policy-coverage lines. Rating agencies typically consider a number of insurers vulnerable, and some underwriters may have large environmental exposures but capped equity resources. Many large commercial enterprises acquire insurance coverage from foreign companies or from subsidiaries of U.S. insurers domiciled in the Caribbean or other countries. The quality of insurance supervision in many foreign countries may not meet the standards expected in the United States.

TYPES OF RISKS

Business risks generally fall into three categories: (1) physical property damage, (2) liability resulting from product failure or unintended employee performance, and (3) loss of key personnel. Common property risks are fires or natural disasters such as storms and earthquakes, but acts of violence or terrorism can also be included in this category. Risk-management programs for property damage should consider not only the protection and replacement of the physical plant, but also the effects of business interruptions, loss of business assets, and reconstruction of records.

Insurance programs increasingly cover the consequences of the second category, product failure or unintended employee performance. These risks include the injury or death of employees, customers, and others; official misconduct; and individual and class-action lawsuits alleging mistreatment or the violation of laws or regulations. All aspects of a bank's operation are susceptible to liability risks. While property-loss levels can be estimated with relative confidence, jury awards for personal injury or product liability, and the related litigation costs, often exceed expectations. In addition, it can be difficult to identify potential sources of liability exposure.

The third category, personnel risk, concerns those exposures associated with the loss of key personnel through death, disability, retirement, or resignation, as well as threats to all employees and third parties arising out of crimes such as armed robbery and extortion. The consequences of personnel loss are often more pronounced in small and medium-sized banks that do not have the financial resources to support a broad level of management.

INSURANCE PROGRAM

Program Objectives

A bank's insurance program should match the objectives of its management, the director-approved risk guidelines, and its individual risk profile. Insurance is primarily the transfer of the financial effect of losses and should be considered as only a part of the broader risk-management process. In that sense, it is imperative that management understands the costs and benefits of the bank's insurance program.

Due to the fluid nature of the insurance market and insurance products, there is no standard program or contract structure. Rather, many different insurance policies, coverages, endorsements, limits, deductibles, and payment plans fit together to form an insurance program. Based on the size and scope of a bank's operations, broader or narrower coverage, higher or lower limits, and separate policies may be purchased. Insurance programs should be customized to the risks that each bank faces. If a bank is particularly susceptible to a specific risk, purchasing additional insurance for that risk may be prudent.

A policy's deductible size and coverages, and the limits purchased, determine how much risk the bank has retained. Likewise, the payment plan of an insurance policy greatly influences the amount of risk transferred. An insurance policy alone does not represent significant risk transfer if the payment plan includes reimbursement to the insurance company for all losses, usually subject to a maximum. These reimbursement, loss-sensitive, or retrospectively rated plans can be viewed more as a risk-financing tool than as risk transfer. Management should understand and quantify the total "all-in" cost of these plans, as well as how these costs correspond with the risk guidelines approved by the directors.

Common Insurance-Policy Components and Concepts

There is a difference between "policy" and "coverage," but the two terms are often used interchangeably. The term "policy" usually refers to the actual insurance contract, while the term "coverage" refers to the types of risks to which the policy is designed to respond. For example, a directors' and officers' policy may include employment-practices liability (EPL) coverage. However, the bank may also purchase a separate EPL policy

An "endorsement" is a modification to a policy. Endorsements can be either a simple change in wording from the original contract or a more complex addition or deletion of a coverage section. To expand on the example above, EPL coverage is often endorsed onto a directors' and officers' policy. When an endorsement adds a coverage to a policy, it is often called a "rider."

The "limit of insurance" is the dollar amount of insurance protection purchased. Each policy has a different limit, and some may have separate limits for separate coverages provided under the same policy. Policies usually include a "per-occurrence" and an "aggregate" limit. The per-occurrence limit is the most the insurer will pay under the policy for any one insured event, while the policy aggregate is the most the insurer will pay in total, regardless of the number and size of insurable events.

"Deductibles" and "self-insured retentions (SIRs)" are the dollar amounts the bank must contribute to the loss before insurance applies.[1] They are effectively the same concept, with the difference being a deductible reduces the limits of insurance while a SIR does not. A deductible is included within or as part of the limits. A SIR is outside or in addition to the provided limits. For example, a $5 million policy limit with a $1 million deductible consists of $4 million of protection and the $1 million deductible. A $5 million policy limit with a $1 million SIR provides $5 million in protection after the $1 million dollar SIR is paid by the bank. As in any clause of an insurance contract, the terms can be negotiated so a deductible does not reduce the limits.

"Occurrence" and "claims made" are two separate types of coverage bases of policies that differ as to the period protected, when claims are recognized, and when the policies are "triggered" or respond. Under an occurrence, or "loss-sustained," form the amount and type of coverage (if any) for the loss event is based on the policy that was in force when the event took place or occurred, regardless of when a claim is submitted. Under a claims-made, or "discovery," policy, the insurance policy in force when the loss event was discovered and reported to the insurance company would apply, regardless of when the event causing the claim occurred. Both types of policies have provisions regarding prompt claims-reporting to insurers. However, claims-made policies are usually stricter and their coverage may be compromised by failing to report claims in a timely manner.

Self-Insurance or Alternative Risk Transfer

There are numerous nontraditional insurance programs that larger, more complex banking organizations employ. These programs include, but are not limited to, captive insurance companies, individual or group self-insurance, risk-retention groups, and purchasing groups. These alternative risk-transfer (ART) programs are complex, and they should include common bank policies and procedures. For example, the bank should have access to individuals with insurance expertise. Outside consultants, qualified insurance brokers, and bank directors or management with insurance expertise are an integral part of a successful ART program. The ART program should also incorporate stop-loss provisions and reinsurance coverage to cap the organization's exposure to severe claims or unexpected loss experience.

COMMON POLICIES AND COVERAGES

The following is not intended to be a comprehensive list of policies and coverages available, but rather a listing and description of those that

1. An organization can maintain an unfunded reserve for loss-retention purposes.

banks most frequently purchase. The list is divided into three general types of insurance: liability, property, and life insurance. A fourth category is included for aircraft and aviation insurance, which consists of various types of property and liability coverage. While this last coverage category may be unnecessary for most banking organizations, for those institutions that do have exposure to risks associated with aircraft ownership, the risks may be exceptionally large.

Fidelity Insurance Bond

Liability insurance is sometimes called "third-party insurance" because three parties are involved in a liability loss: the insured, the insurance company, and the party (the claimant) who is injured or whose property is damaged by the insured. The insurance company pays the claimant on behalf of the insured if the insured is legally liable for the injury or damage. An insured's legal liability for injury is often the result of a negligent act, but there are other sources of liability. Several examples of liability insurance are discussed below.

Fidelity bond coverage provides reimbursement for loss from employee dishonesty; robbery; burglary; theft; forgery; mysterious disappearance; and, in specified instances, damage to offices or fixtures of the insured. Coverage applies to all banking locations except automated teller machines, for which coverage must be specifically added. All banks should obtain fidelity bond coverage that is appropriate for their business needs.

The most widely used form of fidelity bond is the Financial Institution Bond (FIB), Standard Form No. 24 (formerly named the bankers' blanket bond). Standard Form No. 24 is a claims-made, or discovery, form. The "basic" FIB has four insuring agreements or parts. Employee Dishonesty/Fidelity (Clause A) covers dishonest or fraudulent acts committed by employees. On-Premises (Clause B) covers losses from burglary, misplacement, or an unexplained disappearance that occurs on premises. In-Transit (Clause C) covers losses from burglary, misplacement, or an unexplained disappearance that occurs while the property is in transit. Counterfeit Currency (Clause F) covers losses from accepting counterfeit currency.

In addition to the basic four FIB insuring agreements, Forgery or Alteration (Clause D) and Securities (Clause E) may also appear on the standard form. (These coverages may not be a component of the most basic insurance program for a small bank.) Significant enhancements and additional coverages are often endorsed onto the FIB. Any misrepresentation, omission, concealment, or incorrect statement of material fact in the insurance application is grounds for recission of the fidelity bond by the underwriting insurance company.

When the bank under examination is a subsidiary of a bank holding company, and the holding company has purchased one fidelity bond to cover all affiliated banks, the examiner should determine that the policy is sufficient to cover the exposures of the subsidiary bank being examined. Examiners also should determine that any policy premiums the subsidiary bank pays to the parent holding company are not disproportionate to the bank's benefits from the group policy and that such premiums are consistent with the fair-market requirements of section 23B of the Federal Reserve Act. Split-limit coverage may reduce protection if a loss involves the collusion of subsidiary bank employees or other affiliates of a bank holding company.

Clause A: Fidelity (Employee Dishonesty)

Clause A covers losses resulting directly from dishonest or fraudulent acts an officer or employee commits, either acting alone or in collusion with others. The employee must have had a manifest intent to cause a loss to the financial institution, and the employee or another person or entity must obtain financial benefit from the dishonest or fraudulent act. Officers, attorneys retained by the bank, persons provided by an employment contractor, and nonemployee data processors who are performing services for the insured are typically all considered "employees." If any of the loss results from loans, that part of the loss is covered only if the employee was in collusion with other parties to the transaction and the employee received a minimum financial-benefit amount, as specified in the policy. ("Financial benefit" does not include any employee benefits earned in the normal course of employment, including salaries, commissions, fees, bonuses, promotions, awards, profit-sharing plans, or pensions.) Clause A should not prevent the recovery of losses from employee dishonesty that are concealed by fictitious loans.

Clause B: On-Premises

Clause B covers losses of property (as defined in the bond) that occur on premises as a result of robbery, burglary, larceny, misplacement, theft, or a mysterious and unexplained disappearance. Under specified conditions, damage to offices and equipment may be covered under this clause, However, premises coverage should not be confused with standard fire or other types of property insurance.

Clause C: In-Transit

Clause C covers loss of property that is in transit. The property typically must be in the custody of (1) a natural person acting as a messenger for the insured, (2) a transportation company transporting the property in an armored motor vehicle, or (3) a transportation company transporting the property by means other than an armored motor vehicle. When an armored vehicle is not used by a transportation company, "property" is generally limited to records, certified securities, and negotiable instruments that are not payable to the bearer, are not endorsed, and have no restrictive endorsements. Some insuring agreements insure certain financial institution employees that carry cash.

Clause D: Forgery or Alteration

Clause D covers forgery, which is the signing of the name of another person or organization with the intent to deceive. Clause D also covers losses resulting from the alteration of any negotiable instrument. Evidences of debt, which the bank receives either over-the-counter or through clearings, are not usually covered. Fraudulent items received through an electronic funds transfer system are generally excluded.

Clause E: Securities

Clause E covers losses that result from a bank's extending credit or assuming liability on the faith of original securities, documents, or written instruments that are forged, altered, lost, or stolen. These include but are not limited to a certificated security, a title, a deed or mortgage, a certificate of origin or title, an evidence of debt, a security agreement, an instruction to a Federal Reserve Bank, and a statement of uncertificated security of a Federal Reserve Bank. Coverage is included for certain counterfeit securities and instruments. The bank must have acted in good faith and had actual physical possession of the original instrument.

Clause F: Counterfeit Currency

Clause F provides coverage for losses resulting from the receipt of counterfeit money. The coverage is counterfeit money of the United States, Canada, or any other country where the insured maintains a branch office.

Common FIB Extensions, Riders, or Endorsements

Fidelity bond protection can be extended by purchasing additional coverage through extensions, riders, and endorsements. If a bank has significant risk exposures in certain areas, these additional protections should be considered. The most common of these protections are listed below.

Extortion/Threats to Persons or Property

The extortion/threats to persons or property rider insures against loss of property that is surrendered away from a banking office as the result of a threat to do bodily harm to a director, trustee, employee, or relative, or of threats to damage banking premises or property. While a bank may add this coverage with a rider to its FIB, many banks purchase a separate, more comprehensive policy or endorse this coverage onto the directors' and officers' policy.

Trading Losses

The trading-loss rider amends the FIB exclusion by providing coverage for trading losses resulting directly from employee dishonesty.

Automated Teller Machines

The automated teller machine (ATM) rider covers losses of money from, or damage to, an unattended ATM that results from robbery, burglary, or theft.

Electronic or Computer Systems

The electronic or computer-systems rider covers direct losses caused by fraudulent funds transfers originated through the bank's computer systems. The fraud may be caused by a dishonest employee, customer, or third party.

Unauthorized Signatures

The unauthorized-signature rider covers losses resulting from a bank's acceptance, cashing, or payment of any negotiable instrument or withdrawal order that bears an unauthorized signature. An "unauthorized signature" is not forged, but is the signature of an individual who is not an authorized signatory on the account.

Fraudulent Mortgages

The fraudulent-mortgages rider insures against loan losses that result from a bank's accepting or acting on mortgages or deeds of trust that have defective signatures. "Defective signatures" are those obtained through fraud or trickery or under false pretenses.

Counterfeit Checks

The counterfeit-check rider insures against loss from counterfeit checks and other negotiable instruments. The coverage applies whether or not the counterfeit instruments are forged.

Service Contractors

The service-contractor rider covers loss resulting from fraudulent or dishonest acts committed by a servicing contractor. A "servicing contractor" services real estate and home-improvement mortgages, as well as tax and insurance escrow accounts; manages real property; or provides other related services. The coverage extends to losses resulting from the contractor's failure to forward collected funds to the bank when the servicing contractor has committed to do so.

Money-Order Issuer's

With a money-order-issuer's rider, coverage is expanded to authorized third parties that issue registered checks or personal money orders on behalf of the insured.

Liability Insurance

Electronic and Computer Crimes

To broaden the electronic and computer-systems rider that is normally attached to the FIB, an additional electronic and computer-crime rider may be purchased. This rider is a "companion policy" that covers losses the bank may incur from having (1) transferred, paid, or delivered any funds or property; (2) established any credit; or (3) debited any account or given value as a direct result of fraudulent input of electronic data or computer instructions into the insured's computer. These losses may result from someone's unauthorized access to a terminal or the bank's communications lines, or from the fraudulent preparation of tapes or computer programs. Under this rider, coverage may include electronic funds transfer systems, the bank's proprietary systems, and voice instructions given over the telephone. Losses caused by software programmers and consultants, ATM systems, computer viruses, software piracy, computer extortion, and facsimiles may also be covered.

Excess Bank Employee Dishonesty Bond

The excess bank employee dishonesty bond adds limits over and above the FIB. Often an FIB cannot be purchased with limits that are large enough to satisfy the risk-transfer needs of larger banks. When this occurs, the bank may purchase an excess bond that would respond if a claim is larger than the per-occurrence limits on the FIB or if the aggregate limit of the FIB has been exhausted. The most common form of this coverage is the excess bank employee dishonesty blanket bond, Standard Form No. 28.

Combination Safe Depository

Combination safe depository insurance consists of two coverage sections that can be purchased together or separately. Coverage (A) applies to losses when the bank is legally obligated to pay for loss of a customer's property held in safe deposit boxes (including loss from damage or destruction). Coverage (B) generally covers loss, damage, or destruction of property in customers' safe deposit boxes, whether or not the bank is legally liable, when the loss results from an activity other than employee dishonesty, such as robbery or burglary.

Directors' and Officers' Liability

Directors' and officers' (D&O) liability insurance usually has three coverage parts: Side A, Side B, and Entity Securities Coverage (C). Side A covers the directors and officers individually for alleged wrongful acts. Side B reimburses the bank for money it has paid to or on behalf of its directors and officers to indemnify them for damages they may be liable for as a result of alleged wrongful acts. Entity Securities Coverage protects the corporation against securities claims. Subject to many exclusions and definitions, a "wrongful act" means any actual or alleged act, error, omission, misstatement, misleading statement, neglect, or breach of duty. D&O policies are primarily written on a claims-made basis. Larger banks will purchase excess D&O coverage. Like the FIB, there are numerous coverages or enhancements that can be endorsed onto a D&O policy.

Entity errors and omissions. The entity errors and omissions (E&O) insurance rider extends coverage to the financial institution as an entity for wrongful acts. A separate, more robust E&O policy may also be purchased. The separate policy is commonly referred to as bankers' professional liability.

Fiduciary liability and ERISA errors and omissions. Fiduciary liability (or fiduciary errors and omissions) extends insurance coverage for management of the bank's own employee pension or profit-sharing plans. A separate, more robust fiduciary policy may be purchased to expand further the coverage of the bank's management of its own plans. Without this additional special endorsement, neither the fiduciary errors and omissions nor the bank's directors' and officers' liability insurance will cover liability arising under the Employee Retirement Income Security Act of 1974 (ERISA). For protection against exposure arising from a breach of fiduciary duty under ERISA, a special ERISA errors and omissions endorsement is required (also called fiduciary or employee benefit plan liability). In addition to bank trust departments, banks whose only fiduciary responsibilities relate to their employee benefit plan should consider this coverage. A related specialized coverage called IRA/Keogh errors and omissions is also available.

For properties held or managed by a bank's trust department, a master or comprehensive policy is often obtained instead of individual policies. A master policy protects the trust-account properties from fire or other loss and insures the accounts and the bank against third-party liability in connection with the properties. The master policy does not usually cover claims by trust customers against the bank for negligence, errors, or violations resulting in loss to fiduciary accounts. However, separate fiduciary (or trust department) errors and omissions policies incorporate these areas.

Trust Errors and Omissions

Trust errors and omissions insurance provides coverage for wrongful acts while the bank is acting as trustee, guardian, conservator, or administrator. This is a claims-made policy that can be endorsed onto the D&O policy.

Employment-Practices Liability

Employment-practices liability (EPL) insurance provides coverage for an entity against employee claims of wrongful termination, discrimination, sexual harassment or "wrongful employment acts." This is usually a claims-made policy that can be endorsed onto the D&O policy.

Bankers' Professional Liability

Bankers' professional liability (BPL-E&O) provides coverage for claims resulting from any actual or alleged wrongful acts, errors, or omissions bank employees commit in the performance of professional duties. Coverage can be broadened to include securities E&O, insurance agent E&O, brokerage service E&O, and notary E&O.

Mortgage Impairment

Mortgage-impairment insurance coverage protects the bank's interest, as mortgagee, from loss when contractually required insurance on real property held as collateral has inadvertently not been obtained. Upon discovery of the lack of required coverage, the bank has a limited time to either induce the borrower to obtain the required insurance or to place the insurance on its own.

Mortgage Errors and Omissions

Mortgage errors and omissions insurance, a broader version of mortgage-impairment coverage, provides coverage for direct damage and E&O losses to either the bank or the borrower. Mortgage E&O coverage also applies to the bank's mishandling of real estate taxes, life and disability insurance, and escrowed insurance premiums. Claims must result in a loss to the mortgaged property.

Commercial General Liability

Commercial general liability (CGL) insurance protects against claims of bodily injury or property damage for which the business may be liable and which may arise from the bank's premises, operations, and products. In addition to bodily injury and property damage, CGL can include liability coverage for various other offenses that might give rise to claims, such as libel, slander, false arrest, and advertising injury. A CGL policy can be underwritten on either an occurrence or a claims-made basis.

Workers' Compensation and Employers' Liability

Workers' compensation insurance covers injuries or deaths of employees caused by accidents in the course of employment. Workers' compensation insurance consists of two basic coverage parts: statutory benefits and employers' liability (EL). The two are mutually exclusive remedies to an employee injured on the job. EL protects a company from a lawsuit filed by an employee, while statutory benefits coverage provides medical care and long-term disability, death, or other benefits. State laws govern these provisions, so the provisions differ from state to state. The statutory coverage of workers' compensation is a no-fault system intended to benefit both the injured employee and the employer.

Automobile Liability and Physical Damage

Automobile liability insurance provides third-party liability protection for bodily injury or property damage resulting from accidents that involve the bank's vehicles. First-party coverage for damage to the vehicles is also provided. This coverage should be extended to include—

- nonowned and hired coverage, if employees use personal autos or rent autos while on bank business;
- coverage for autos that have been repossessed; and
- garage-keeper's liability, if the bank rents its parking facilities to customers or the public.

Umbrella and Excess Liability

Umbrella and excess liability insurance offers additional liability limits in excess of the coverage limits of any policy over which it "attaches" or becomes effective. Basic umbrella coverage attaches to CGL and automobile insurance and to the employers' liability section of workers' compensation policies. An excess liability policy attaches over an umbrella policy. More complex insurance programs may include both umbrella and excess liability policies that attach over the D&O, E&O, EPL, or other insurance.

Property Insurance

Several types of insurance coverage are available to help banks recover from property damage. Some of the more common types of property coverages are briefly described below.

Broad Form Property Insurance

Property insurance insures against the loss of or damage to real and personal property. The loss or damage may be caused by perils such as fire, theft, windstorm, hail, explosion, riot, aircraft, motor vehicles, vandalism, malicious mischief, riot and civil commotion, and smoke.

Fire

Fire insurance covers all losses directly attributed to fire, including damage from smoke or water and chemicals used to extinguish the fire. Additional fire damage for the building contents may be included, but often is written in combination with the policy on the building and permanent fixtures. Most fire insurance policies contain "co-insurance" clauses, meaning that insurance coverage must be maintained at a fixed proportion of the replacement value of the building. If a bank fails to maintain the required relationship of protection, all losses will be reimbursed at the ratio of the amount of the insurance carried to the amount required, applied to the value of the building at the time of the loss. When determining insurable value for fire insurance purposes, the basis typically is the cost of replacing the property with a similar kind or quality at the time of loss. Different types of values, however, may be included in policies, and care should be taken to ensure that the bank is calculating the correct value for its needs.

Business Personal Property

Traditionally known as "contents" insurance, business personal property insurance affords insurance protection coverage for the furniture, fixtures, equipment, machinery, merchandise, materials, and all other personal property owned by the bank and used in its business.

Blanket Coverage

Blanket insurance covers, in a single contract, either multiple types of property at a single location or one or more types of property at multiple locations.

Builder's Risk

Builder's-risk insurance is commercial property coverage specifically for buildings that are in the course of construction.

Business Interruption

Business-interruption insurance indemnifies the insured against losses arising from its inability to continue normal operations and functions of the business. Coverage is triggered by the total or partial suspension of business operations due to the loss of, loss of use of, or damage to all or part of the bank's buildings, plant machinery, equipment, or other personal property, when the loss is the result of a covered cause.

Contingent business-interruption insurance is also available to cover the bank's loss of earnings caused by a loss to another business that is one of its major suppliers or customers. This insurance is also known as "business income from dependent properties."

Crimes

Crime insurance covers money, securities, merchandise, and other property from various criminal causes of loss, such as burglary, robbery, theft, and employee dishonesty.

Data Processing

Data processing insurance coverage provides loss protection if data processing systems break down. This insurance also covers the additional expense incurred in making the system operational again.

Difference in Conditions

A difference-in-conditions (DIC) insurance contract is a separate coverage that expands or supplements property insurance that was written on a named-perils basis. A DIC policy will cover the property on an all-risk basis, subject to certain exclusions.

Ocean and Inland Marine

Ocean marine insurance covers ships and their cargo against such causes as fire, lightning, and "perils of the seas." These include high winds, rough waters, running aground, and collision with other ships or objects.

Inland marine insurance was originally developed to provide coverage for losses to cargo transported over land. It now covers limited types of property in addition to goods in transit.

Valuable Papers and Destruction of Records

Valuable-papers and destruction-of-records insurance coverage is for the physical loss or damage to valuable papers and records of the insured. The coverage includes practically all types of printed documents or records except money.

Accounts Receivable

Accounts-receivable insurance covers losses that occur when an insured is unable to collect outstanding accounts because of damage to or destruction of the accounts-receivable records that was caused from a peril covered in the policy.

Cash Letters

Cash-letter insurance covers the costs for reproducing cash-letter items and items that remain uncollectible after a specified period of time. Generally, these policies do not cover losses due to dishonest acts of employees.

First-Class, Certified, and Registered Mail

The insurance coverage for first-class, certified, and registered mail provides protection on the shipment of property sent through the mail, as well as during transit by messenger or carrier to and from the post office. The insurance is principally used to cover registered mail in excess of the maximum $25,000 insurance provided by the U.S. Postal Service.

Commercial Multiple Peril

Commercial multiple peril insurance encompasses a range of insurance coverages, including property and liability. Small institutions may purchase this package policy when stand-alone polices are excessive or inefficient.

Life Insurance

Common types of life insurance policies purchased by banks are described below.

Key Person

When the death of a bank officer, or key person, would be of such consequence to the bank as to give it an insurable interest, key-person life insurance would insure the bank on the life of this individual.

Split-Dollar

In split-dollar life insurance, the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, death benefit, or both. See SR-93-37 ("Split-Dollar Life Insurance," June 18, 1993) and its attachments for further discussion of the Federal Reserve's position on these arrangements between bank holding companies and their subsidiary banks.

Bank-Owned

Bank-owned life insurance consists of tax-advantaged insurance policies that are purchased to cover the lives of bank officers and other highly compensated employees. The policies may be used as a funding mechanism for employee pension and benefit plans. The bank is the owner and beneficiary of the policy, and the cash value of the policy is considered an asset of the bank.

Aircraft or Aviation Insurance

Although aviation-liability exposures are frequently overlooked in the myriad of other financial institution exposures, they have tremendous potential for large catastrophic losses and must be addressed by senior risk-management executives at all financial institutions. Often hidden or obscure, aviation liability ranges from the more typical owned and nonowned liability and physical-damage exposures to the more exotic exposures from hangar-keepers, aviation products, and airport or heliport premises. In view of the specialized nature of aviation exposures, it is important that the bank deal with knowledgeable and experienced agents or brokers and underwriters in developing its aviation insurance program. While exposure categories overlap significantly, the following summary highlights the key areas of concern to most financial institutions.

Aviation Liability

Aviation liability insurance can be written to include aviation-products liability, all owned or nonowned exposures, and passenger liability. A bank's umbrella liability insurance program should also apply over the aviation policy's limit.

Nonowned Exposures

While many banks do not feel the need for aviation insurance because they do not own an aircraft, they may overlook liability exposures from nonowned aircraft and may, in fact, need this coverage. For example, an employee may use a personal aircraft on bank business, or lease or rent an aircraft to ferry customers or employees to a distant meeting. Financing or leasing an aircraft could create a nonowned exposure, even though the aircraft is not under bank control.

Most aviation-underwriting markets have programs available to meet the above exposures. However, additional exposures may require special coverage. Banks should consider the following situations:

- If the bank repairs and maintains the aircraft, it may incur a products-liability exposure after control is relinquished to others, such as when the aircraft is sold.
- If the bank finances aircraft, maintaining only a security interest, it becomes an owner when it repossesses the aircraft. In this case, there could be a definite need for both liability and physical-damage coverage. The coverage may be written at the time of repossession or negotiated in advance of the need for it. The bank should not attempt to continue coverage for its exposure under the borrower's policy.

All-Risk Physical Damage

To protect the bank's security interest in an aircraft hull, borrowers should be required to maintain full-value, all-risk physical-damage insurance (both ground-risk and in-flight coverage) in favor of the bank. However, a number of warranties in aircraft insurance policies could void the contract, so bankers are further advised to require that a borrower's hull insurance policy contain a breach-of-warranty endorsement to protect the bank if the borrower or owner violates provisions of the policy. The underwriter should agree to give the bank at least 30 days' advance notice of any change in the policy. Depending on the use of the aircraft, special consideration should be given to the territorial limits of coverage, as well as to confiscation protection. Since breach-of-warranty endorsements, like aircraft insurance policies, are far from standard, it is important that the bank understand and agree with the underwriter's language. It is particularly appropriate to review the consequences of potential recovery to the lien holder if the aircraft is damaged while a delinquency exists on the note.

Bank as Lessor

If the bank's security interest is that of the lessor, aviation liability insurance should be carried by the bank as lessor and also by the customer as lessee. In certain cases, it may be appropriate to require the lessee, through his or her underwriter, to provide the equivalent of the breach-of-warranty endorsement to the liability program and physical-damage coverage. The bank may also consider obtaining contingent lessor's liability.

Airport Premises and Hangar-Keepers

Airport-premises and hangar-keeper's insurance apply if the bank repossesses real estate on which an airport facility exists and continues to operate, or if the bank permits use of the facility pending further sale. In either case, the bank may assume liability exposures associated with the control tower, as well as airport-premises liability. Both the bank's comprehensive general liability and aviation liability programs should be reviewed for proper coverage.

If the bank owns or operates a hangar for its aircraft and attempts to share the burden of costs with others by renting aircraft space, it can pick up exposure to hangar-keeper's liability, unless the contract is properly worded. Appropriate consideration should be given to hold-harmless indemnification clauses, any regular or special insurance requirements, and waivers of subrogation.

Accidental Death and Dismemberment and Travel

Accidental death and dismemberment and travel insurance is another aspect of aviation insurance that banking institutions should consider. Many insurance programs for accidental death and dismemberment and corporate business travel accidents exclude coverage in corporate-owned, -leased, or -hired aircraft. Banks need to review the language of these policies carefully to be certain that they provide necessary and adequate coverages for the use of such aircraft.

RECORDKEEPING

The diversity of available insurance policies and their coverages emphasize the need for banks to maintain a concise, easily referenced schedule of their insurance coverage, referred to as the "schedule of insurance." These records should include the following information:

- insurance coverages provided, with major exclusions detailed
- the underwriter
- deductible amounts
- upper limits on policies
- terms of the policies
- dates that premiums are due
- premium amounts
- claim-reporting procedures

In preparation for policy renewal, the bank's risk manager and insurance broker organize much of the bank's relevant insurance data into a "submission." The submission may include—

- historical, current, and forecasted exposure information, such as sales, number and type of employees, property characteristics and values, and number and type of autos;
- loss and claim history by line of insurance, including detailed information on large claims, loss development, and litigation;
- information on company risk-management policies and financials; and
- specifications on desired coverages, terms and conditions, limits, deductibles, and payment plans.

The submission is delivered to the insurance company underwriter and forms the basis for determining premiums, rates, limits, and the program structure. The information may give the examiner a sense of why premiums and coverages change from year to year and whether purchased limits are sufficient.

Banks should retain the original policies and supporting documents for appropriate time periods. Records of losses should also be maintained, regardless of whether the bank was reimbursed. This information indicates areas where internal controls may need to be improved and is useful in measuring the level of risk exposure in a particular area.

1. To determine whether insurance is effectively integrated into the operational-risk-management program, and whether the insurance is appropriate, in light of the institution's internal-control environment.
2. To determine if insurance coverage adequately protects against significant or catastrophic loss.
3. To determine if recordkeeping practices are sufficient to enable effective risk and insurance management.
4. To ascertain if, and ensure that, the risk manager has initiated corrective action when policies, practices, procedures, or internal controls are deficient or when violations of banking laws and regulations have been noted.

1. If selected for implementation, complete or update the ‘‘Bank Risk and Insurance Management’’ section of the internal control questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. From the examiner who is assigned to ‘‘internal control,’’ obtain a listing of any deficiencies noted in the latest review conducted by internal or external auditors and risk managers. Determine if appropriate corrections have been made.
3. Determine if the bank has designated a qualified risk manager, with expertise in insurance programs, to be responsible for loss control. If not, determine which officer handles the risk- and insurance-management function and whether external consultants are employed in designing the insurance program.
4. Obtain the bank’s schedule of insurance policies in force and the renewal submissions. If the bank does not maintain a schedule, request that the bank complete a schedule of existing insurance coverage.
   a. Determine whether there have been any material changes in insurance coverage, limits, or deductibles since the last examination and the reasons for such changes. Do the changes reflect—
      - revised business strategies, the bank structure, operating processes, or technology systems that affect insurable risks, and
      - shifts to self-insurance or co-insurance or a change in insurance carriers?
   b. If there have been material changes, determine how they are being managed.
5. Using the bank-prepared summary of insurance coverage, determine that coverage conforms to the guidelines for maximum loss exposure, as established by the board of directors.
   a. Determine whether the use of insurance is in accordance with board-approved risk-management policies and guidelines.
   b. If the bank self-insures, determine what methods are used for this purpose; how the value of self-insurance is quantified; and how ‘‘premiums’’ are accounted for, funded, allocated, and tracked.
6. Determine whether insurance coverage provides adequate protection for the bank. The quality of internal controls and the audit function must be considered when making this assessment.
   a. Determine whether the bank manages its insurance coverage as an element of the operational-risk-management program.
   b. Determine whether the insurance program is managed on a corporate-wide basis or within each business unit.
   c. Identify any products, processes, or systems that the bank is not able to obtain insurance coverage for and determine how the associated risk is being managed.
   d. Determine whether the bank maintains a database of operational-loss events, the comprehensiveness of the database, and the claims history of operational losses.
   e. Review the due-diligence process used to assess the qualifications of providers of insurance coverage, including primary reinsurers.
7. If the bank’s fidelity insurance has lapsed, determine that the appropriate Federal Reserve Bank has been notified.
8. Determine that the bank has adequate procedures to ensure that—
   a. reports of losses are filed with the bonding company pursuant to policy provisions,
   b. premiums are paid before policy expiration dates,
   c. policies are renewed without a lapse of coverage at expiration dates, and
   d. material changes in exposures are reported to the bank’s insurance agent or broker and result in appropriate insurance-policy endorsements.

If the procedures are deficient, verify that reports have been filed as required and premiums have been paid.

9. Review any significant financial institution bond claims that were filed since the last examination to determine—

   a. any adverse effect on the bank's condition,
   b. whether the incident (or incidents) reflects any deficiencies with respect to internal controls and procedures, and
   c. whether management has taken appropriate steps to correct any deficiencies and made appropriate reports to the board of directors.
10. Prepare, in appropriate report form, and discuss with appropriate officers—
   a. recommended corrective action when policies, practices, procedures, or internal controls are deficient;
   b. recommended improvements in the risk-management program that relate to insurance;
   c. important areas in which insurance coverage is either nonexistent or inadequate in view of current circumstances; and
   d. any other deficiencies noted.
11. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for its own insurance coverage. The bank's risk-management system should be documented completely and concisely and should include, where appropriate, the risk-assessment matrix, a narrative description, flowcharts, the schedule of insurance coverage, policy forms, renewal submissions, and other pertinent information.

BANK RISK AND INSURANCE MANAGEMENT

1. Does the bank have established insurance guidelines that provide for—
   a. a reasonably frequent, and at least annual, determination of risks the bank assumes or transfers, including high-dollar and low-probability events?
   b. limits as to the amount of risk that may be retained or self-insured?
   c. periodic appraisals of major fixed assets to be insured?
   d. a credit or financial analysis of the insurance companies who have issued policies to the bank?
2. Does the bank have a risk manager who is responsible for assessing and developing controls to deal with the consolidated risks of the institution?
3. Is the bank's insurance program managed as an element of its overall operational-risk-management program; that is, are insurance coverages reviewed and coordinated by the person handling the operational-risk-management function?
4. Does the bank use the services of a professionally knowledgeable insurance agent, broker, direct writer, or consultant to assist in selecting and providing advice on alternative means of providing insurance coverage?
5. Does the bank's security officer coordinate his or her activities with the person responsible for handling the operational-risk-management function?
6. Does the bank maintain a concise, easily referenced schedule of existing insurance coverage?
7. Does the bank maintain records, by type of risk, to facilitate an analysis of the bank's experience in costs, claims, losses, and settlements under the various insurance policies in force?
8. Is a complete schedule of insurance coverage presented to the board of directors at least annually for review and approval? Does the schedule include the respective insurance premiums (net costs), claims, and loss experience, and is this information reviewed as part of this process?

CONCLUSION

1. Is the foregoing information an adequate basis for evaluating internal control; that is, 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.
2. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

State member banks may purchase bank-owned life insurance (BOLI) as principal if such purchases are permitted for national banks and permitted under state law. The legal authority and guidance for acquiring permissible BOLI and for engaging in insurance activities is discussed within the following interagency statement. When such insurance purchases or insurance activities are not permissible for national banks, a determination of permissibility depends on a decision of the FDIC (1) that the investment or activity would not pose any significant risk to the insurance fund and (2) that the bank continues to comply with the required capital standards.

The bank supervisory agencies have concerns that some banks have committed a significant amount of capital to BOLI without having an adequate understanding or a proper assessment of the full array of risks it poses—especially risks that are difficult to measure, such as liquidity, transaction/operational, reputation, and compliance/legal risks. Banks are therefore expected to implement appropriate risk-management processes, including meaningful risk limits, before implementing or adding to a BOLI program. The following interagency guidance was developed for banks and savings associations (institutions) and examination staff to help ensure that risk-management practices for BOLI are consistent with safe and sound business practices. The interagency statement was issued on December 7, 2004.

INTERAGENCY STATEMENT ON THE PURCHASE AND RISK MANAGEMENT OF LIFE INSURANCE

This interagency statement[1] provides general guidance for banks and savings associations (institutions) regarding supervisory expectations for the purchase of and risk management for BOLI. Guidance is also provided for split-dollar arrangements and the use of life insurance as security for loans. The agencies are providing this guidance to help ensure that institutions' risk-management processes for BOLI are consistent with safe and sound banking practices. Among the safe and sound banking practices discussed in this statement are (1) the need for senior management and board oversight of BOLI, including both a thorough pre-purchase analysis of risks and rewards and post-purchase risk assessment and (2) the permissibility of BOLI purchases and holdings, as well as their risks and associated safety-and-soundness considerations. The statement's appendix [titled appendix A for this section of the manual] contains a discussion of insurance types and the purposes for which institutions commonly purchase life insurance, as well as a glossary of BOLI-related terminology [titled appendix B for this section].

The statement's guidance for the pre-purchase analysis of life insurance applies to all BOLI contracts entered into after December 7, 2004. The guidance concerning the ongoing risk management of BOLI subsequent to its purchase applies to all holdings of life insurance regardless of when purchased. Institutions that purchase life insurance after December 7, 2004, that are not in compliance with this guidance may be subject to supervisory action. Institutions that entered into BOLI contracts before this date will be evaluated according to each agency's pre-purchase guidance in effect at that time.

Compliance with the supervisory guidance in this statement regarding permissible uses for insurance (e.g., recovery of the costs of providing benefits) does not determine whether the policy satisfies state insurable interest requirements.

Legal Authority

National banks may purchase and hold certain types of life insurance under 12 USC 24 (Seventh), which provides that national banks may exercise "all such incidental powers as shall be necessary to carry on the business of banking." Federal savings associations also may purchase and hold certain types of life insurance incidental to the express powers granted under the Home Owners' Loan Act. The OCC and OTS have delineated the scope of these authorities through various interpretations addressing the

1. Adopted by the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (the agencies).

permissible use of life insurance by national banks and federal savings associations.

Under these authorities, national banks and federal savings associations may purchase life insurance in connection with employee compensation and benefit plans, key-person insurance, insurance to recover the cost of providing pre- and post-retirement employee benefits, insurance on borrowers, and insurance taken as security for loans. The OCC and OTS may approve other uses on a case-by-case basis.

National banks and federal savings associations may *not* purchase life insurance—

- for speculation;
- to provide funds to acquire shares of stock from the estate of a major shareholder upon the shareholder's death, for the further purpose of controlling the distribution of ownership in the institution;
- as a means of providing estate-planning benefits for insiders, unless the benefit is a part of a reasonable compensation package; or
- to generate funds for normal operating expenses other than employee compensation and benefits.

National banks and federal savings associations may not hold life insurance in excess of their risk of loss or cost to be recovered. For example, once an individual no longer qualifies as a key person because of retirement, resignation, discharge, change of responsibilities, or for any other reason, the risk of loss has been eliminated. Therefore, national banks and federal savings associations may be required to surrender or otherwise dispose of key-person life insurance held on an individual who is no longer a key person. Typically, term or declining term insurance is the most appropriate form of life insurance for key-person protection.

National banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account[2] of the insurance company) only for the purpose of economically hedging their equity-linked obligations under employee benefit plans. As discussed more fully in the section on "Price Risk," for equity-linked variable life insurance holdings to be permissible, the national bank or federal savings association must demonstrate that—

- it has a specific, equity-linked obligation; and
- both at the inception of the hedge and on an ongoing basis, changes in the value of the equity-linked variable life insurance policy are highly correlated with changes in the value of the equity-linked obligation.

If a national bank or federal savings association does not meet these requirements, the equity-linked variable life insurance holdings are not permissible. The use of equity-linked variable life insurance holdings as a long-term hedge against general benefit costs is not permissible because the life insurance is not hedging a specific equity-linked liability and does not meet the "highly correlated" requirement.

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. In some instances, state laws permit state-chartered banks to engage in activities (including making investments) thatgo beyond the authority of a national bank. The Federal Deposit Insurance Act (section 24) generally requires insured state-chartered banks to obtain the FDIC's consent before engaging as principal in activities (including making investments) that are not permissible for a national bank. Similarly, the Federal Deposit Insurance Act (section 28) generally requires a state-chartered savings association to obtain the FDIC's consent prior to engaging as principal in activities (including making investments) that are not permissible for a federal savings association. While insured state-chartered banks and state savings associations may seek the FDIC's consent to make purchases of life insurance that would not be within the authority of a national bank or federal savings association, such banks and savings associations should be aware that the FDIC will not grant permission to make life insurance purchases if the FDIC determines that doing so would present a significant risk to the deposit insurance fund or that engaging in such

2. A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's cash surrender value is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (e.g., timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

purchases is inconsistent with the purposes of federal deposit insurance.

Accounting Considerations

Institutions should follow generally accepted accounting principles (GAAP) applicable to life insurance for financial and regulatory reporting purposes. Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4), discusses how to account for holdings of life insurance. Under TB 85-4, only the amount that could be realized under an insurance contract as of the balance-sheet date (that is, the CSV reported to the institution by the carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. The guidance set forth in TB 85-4 concerning the carrying value of insurance on the balance sheet is generally appropriate for all forms of BOLI.

An institution may purchase multiple permanent insurance policies from the same insurance carrier with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance-sheet date whether one or more of the policies will be surrendered before the deaths of those insured, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. Under FASB Statement No. 5, "Accounting for Contingencies," "[c]ontingencies that might result in gains usually are not reflected in the accounts since to do so might be to recognize revenue prior to its realization." Accordingly, an institution should report each of the insurance policies on its balance sheet at the policy's CSV reported by the insurance carrier, less any applicable surrender charges not reflected in the reported CSV, without regard to the existence of the rider.

In accordance with the instructions for Consolidated Reports of Condition and Income and Thrift Financial Reports, an institution should report the carrying value of its BOLI holdings as an "other asset" and the earnings on these holdings should be reported as "other noninterest income."

The agencies have seen a number of cases in which institutions have failed to account properly for a type of deferred compensation agreement, commonly referred to as a revenue-neutral plan or an indexed retirement plan. The accounting for such plans is separate and distinct from the accounting for BOLI. However, because many institutions buy BOLI to help offset the cost of providing such deferred compensation, the agencies have issued guidance addressing the accounting requirements for both deferred compensation agreements and BOLI. See the Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance, dated February 11, 2004, for a complete description, including examples, of the appropriate accounting treatment.

Supervisory Guidance on BOLI

Before entering into a BOLI contract, institutions should have a comprehensive risk-management process for purchasing and holding BOLI. A prudent risk-management process includes—

- effective senior management and board oversight;
- comprehensive policies and procedures, including appropriate limits;
- a thorough pre-purchase analysis of BOLI products; and
- an effective ongoing system of risk assessment, management, monitoring, and internal control processes, including appropriate internal audit and compliance frameworks.

The risks associated with temporary (term) insurance are significantly less than those arising from holdings of permanent insurance. Accordingly, the risk-management process for temporary insurance may take this difference into account and need not be as extensive as the risk-management process for permanent insurance.

Senior Management and Board Oversight

The safe and sound use of BOLI depends on effective senior management and board oversight. Regardless of an institution's financial capacity and risk profile, the board must understand the complex risk characteristics of the institution's insurance holdings and the role this asset is intended to play in the institution's overall business strategy. Although the board may delegate decision-making authority related to purchases of BOLI to senior management, the board remains ultimately responsible for ensuring that the purchase and holding of BOLI is consistent with safe and sound banking practices.

An institution holding life insurance in a manner inconsistent with safe and sound banking practices is subject to supervisory action. Where ineffective controls over BOLI risks exist, or the exposure poses a safety-and-soundness concern, the appropriate agency may take supervisory action against the institution, including requiring the institution to divest affected policies, irrespective of potential tax consequences.

Policies and Procedures

Consistent with prudent risk-management practices, each institution should establish internal policies and procedures governing its BOLI holdings, including guidelines that limit the aggregate CSV of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. When establishing these internal CSV limits, an institution should consider its legal lending limit, the capital concentration threshold, and any applicable state restrictions on BOLI holdings.[3] In this regard, given the liquidity, transaction/operational, reputation, and compliance/legal risks associated with BOLI, it is generally not prudent for an institution to hold BOLI with an aggregate CSV that exceeds 25 percent of the institution's capital as measured in accordance with the relevant agency's concentration guidelines.[4] Therefore, the agencies expect an institution that plans to acquire BOLI in an amount that results in an aggregate CSV in excess of 25 percent of capital, or any lower internal limit, to gain prior approval from its board of directors or the appropriate board committee. The agencies particularly expect management to justify that any increase in BOLI resulting in an aggregate CSV above 25 percent of capital does not constitute an imprudent capital concentration. An institution holding BOLI in an amount that approaches or exceeds the 25 percent of capital concentration threshold can expect examiners to more closely scrutinize the risk-management policies and controls associated with the BOLI assets and, where deficient, to require corrective action.

When seeking the board's approval to purchase or increase BOLI, management should inform the board members of the existence of this interagency statement, remind them of the illiquid nature of the insurance asset, advise them of the potential adverse financial impact of early surrender, and identify any other significant risks associated with BOLI. Such risks might include, but are not limited to, the costs associated with changing carriers in the event of a decline in the carrier's creditworthiness and the potential for noncompliance with state insurable interest requirements and federal tax law.

Pre-purchase Analysis

The objective of the pre-purchase analysis is to help ensure that the institution understands the risks, rewards, and unique characteristics of BOLI. The nature and extent of this analysis should be commensurate with the size and complexity of the potential BOLI purchases and should also take into account existing BOLI holdings. A mark of a well-managed institution is the maintenance of adequate records concerning its pre-purchase analyses, usually including documentation of the purpose and amount of insurance needed.

An effective pre-purchase analysis involves the following management actions:

Step 1—Identify the need for insurance and determine the economic benefits and appropriate insurance type. An institution should deter-

3. In July 1999, the OTS adopted a policy that savings associations may not invest more than 25 percent of their total capital in BOLI without first notifying and obtaining authorization from their OTS Regional Office. In order to maintain strong and effective communications with institutions under its supervision, the OTS retains this policy. The other agencies may also institute approval or notification requirements.

4. Each agency's definition of a concentration differs slightly. Institutions should refer to the definition provided by their supervisory agency when measuring the CSV of BOLI as a percentage of capital: OCC Bulletin 95-7 for national banks; FRB *Commercial Bank Examination Manual,* section 2050.1, for state member banks; FDIC *Manual of Examination Policies,* section 11.1, for insured state nonmember banks; and OTS *Thrift Activities Handbook,* section 211, for savings associations.

mine the need for insurance by identifying the specific risk of loss to which it is exposed or the specific costs to be recovered. It is not appropriate to purchase life insurance to recover a loss that the institution has already incurred. An institution's purchase of insurance to indemnify it against a specific risk of loss does not relieve it from other responsibilities related to managing that risk. The type of BOLI product, e.g., general[5] or separate account, and its features should be appropriate to meet the identified needs of the institution. The appendix [appendix A] contains a description of insurance types and design features.

An institution should analyze the cost and benefits of planned BOLI purchases. The analysis should include the anticipated performance of the BOLI policy and an assessment of how the purchase will accomplish the institution's objectives. Before purchasing BOLI, an institution should analyze projected policy values (CSV and death benefits) using multiple illustrations of these projections provided by the carrier, some of which incorporate the institution's own assumptions. An institution should consider using a range of interest-crediting rates and mortality-cost assumptions. In some cases, the net yield (after mortality costs) could be negative, particularly for separate-account products. The potential for unfavorable net yields underscores the importance of carefully evaluating BOLI costs and benefits across multiple scenarios, both currently and into the future.

Step 2—Quantify the amount of insurance appropriate for the institution's objectives. An institution should estimate the size of the employee benefit obligation or the risk of loss to be covered and ensure that the amount of BOLI purchased is not excessive in relation to this estimate and the associated product risks. When using BOLI to recover the cost of providing employee benefits, the estimated present value of the expected future cash flows from BOLI, less the costs of insurance, should not exceed the estimated present value of the expected after-tax employee benefit costs. In situations where an institution purchases BOLI on a group of eligible employees, it may estimate the size of the obligation or the risk of loss for the group on an aggregate basis and compare that to the aggregate amount of insurance to be purchased. This estimate should be based on reasonable financial and actuarial assumptions. State insurable interest laws may further restrict or limit the amount of insurance that may be purchased on a group of employees. Management must be able to support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the institution, including the rationale for its discount rates and cost projections.

Step 3—Assess the vendor's qualifications. When making a decision about vendors, an institution should consider its own knowledge of insurance risks, the vendor's qualifications, and the amount of resources the institution is willing to spend to administer and service the BOLI. Depending on the role of the vendor, the vendor's services can be extensive and may be critical to successful implementation and operation of a BOLI plan, particularly for the more complex separate-account products.

While it is possible to purchase insurance directly from insurance carriers, the vast majority of insurance purchases are made through vendors—either brokers, consultants, or agents. A vendor may design, negotiate, and administer the BOLI policy. An institution should ensure that it understands the product it is purchasing and that it selects a product that best meets its needs. Management, not just the vendor, must demonstrate a familiarity with the technical details of the institution's insurance assets, and be able to explain the reasons for and the risks associated with the product design features they have selected.

An institution that uses a vendor should make appropriate inquiries to satisfy itself about the vendor's ability to honor its long-term commitments, particularly when the vendor is expected to be associated with the institution's insurance program over an extended period of time. The institution should evaluate the adequacy of the vendor's services and its reputation, experience, financial soundness, and commitment to the BOLI product. Vendors typically earn a large portion of their commissions upon the sale of the product, yet they often retain long-term servicing responsibilities for their clients. The vendor's commitment to investing in the operational infrastructure necessary to support BOLI is a key consideration in vendor selection.

5. A general account is a design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policyholder's CSV.

An institution should be aware that the vendor's financial benefit from the sale of insurance may provide the vendor with an incentive to emphasize the benefits of a BOLI purchase to the institution without a commensurate explanation of the associated risks. Therefore, reliance solely upon pre-packaged, vendor-supplied compliance information does *not* demonstrate prudence with respect to the purchase of insurance. An institution should not delegate its selection of product design features to its vendors. An institution that is unable to demonstrate a thorough understanding of BOLI products it has purchased and the associated risks may be subject to supervisory action.

Step 4—Review the characteristics of the available insurance products. There are a few basic types of life insurance products in the marketplace. These products, however, can be combined and modified in many different ways. The resulting final product can be quite complex. Furthermore, certain permanent insurance products have been designed specifically for banks. These products differ from other forms of corporate-owned life insurance (COLI) policies in that the policies designed for banks are generally structured without surrender or front-end sales charges in order to avoid having to report these charges as expenses when initially recording the carrying value. However, BOLI products may have lower net yields than COLI products due to the absence of these charges. An institution should review the characteristics of the various insurance products available, understand the products it is considering purchasing, and select those with the characteristics that best match the institution's objectives, needs, and risk tolerance.

Design features of permanent insurance policies determine (1) whether the policy is a general account, separate account, or hybrid product;[6] (2) whether the insurance contract is a modified endowment contract (MEC) that carries certain tax penalties if surrendered; and (3) the method used to credit earnings to the policy. Some implications of these design features are discussed in more detail in the "Risk Management of BOLI" section of this interagency statement.

When purchasing insurance on a key person or a borrower, management should consider whether the institution's need for the insurance might end before the insured person dies. An institution generally may not hold BOLI on a key person or a borrower once the key person leaves the institution or the borrower has either repaid the loan, or the loan has been charged off. Therefore, the maturity of the term or declining term insurance should be structured to match the expected tenure of the key person or the maturity of the loan, respectively. Permanent insurance generally is not an appropriate form of life insurance under these circumstances.

Step 5—Select the carrier. To achieve the tax benefits of insurance, institutions must hold BOLI policies until the death of the insured. Therefore, carrier selection is one of the most critical decisions in a BOLI purchase and one that can have long-term consequences. While a broker or consultant may assist the institution in evaluating carrier options, the institution alone retains the responsibility for carrier selection. Before purchasing life insurance, an institution should perform a credit analysis on the selected carrier(s) in a manner consistent with safe and sound banking practices for commercial lending. A more complete discussion of the credit-analysis standards is included in the "Credit Risk" section of this interagency statement.

Management should review the product design, pricing, and administrative services of proposed carriers and compare them with the institution's needs. Management should also review the carrier's commitment to the BOLI product, as well as its credit ratings, general reputation, experience in the marketplace, and past performance. Carriers not committed to general-account BOLI products may have an incentive to lower the interest-crediting rate on BOLI over time, reducing the favorable economics of the product. The interest-crediting rate refers to the gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value. Insurance companies frequently disclose both a current interest-crediting rate and a guaranteed minimum interest-crediting rate. Institutions should be aware that the guaranteed minimum interest-crediting rate may be periodically reset in accordance with the terms of the insurance contract. As a result, the potential exists for a decline in the interest-crediting rate.

6. A hybrid product combines features of both general- and separate-account products.

While institutions can exercise what is known as a 1035 exchange[7] option to change carriers, there are some practical constraints to using this option. First, the institution must have an insurable interest in each individual to be insured under the new carrier's policy. In a 1035 exchange, former employees of the institution may not be eligible for coverage under the new policy because state insurable interest laws may prohibit their eligibility. Second, the original carrier may impose an exchange fee specifically applicable to such 1035 exchanges.

Step 6—Determine the reasonableness of compensation provided to the insured employee if the insurance results in additional compensation. Insurance arrangements that are funded by the institution and that permit the insured officer, director, or employee to designate a beneficiary are a common way to provide additional compensation or other benefits to the insured. Split-dollar life insurance arrangements are often used for this purpose. Before an institution enters into a split-dollar arrangement or otherwise purchases insurance for the benefit of an officer, director, or employee, the institution should identify and quantify its compensation objective and ensure that the arrangement is consistent with that objective. The compensation provided by the split-dollar or other insurance arrangement should be combined with all other compensation provided to the insured to ensure that the insured's total compensation is not excessive. Excessive compensation is considered an unsafe and unsound banking practice. Guidelines for determining excessive compensation can be found in the Interagency Guidelines Establishing Standards for Safety and Soundness.[8]

Because shareholders and their family members who are not officers, directors, or employees of an institution do not provide goods or services to the institution, they should not receive compensation from the institution. This includes compensation in the form of split-dollar life insurance arrangements.

Prior to an institution's purchase of a life insurance policy to be used in a split-dollar life insurance arrangement, the institution and the insured should enter into a written agreement. Written agreements usually describe the rights of the institution, the insured individual, and any other parties (such as trusts or beneficiaries) to the policy's CSV and death benefits. It is important for an institution to be aware that ownership of the policy by the employee, a third party, or a trust (non-institution owner) may not adequately protect the institution's interest in the policy because the institution ordinarily will not have the sole right to borrow against the CSV or to liquidate the policy in the event that funds are needed to provide liquidity to the institution. Moreover, if a non-institution owner borrows heavily against the CSV, an institution's ability to recover its premium payments upon the death of the insured may be impaired.

At a minimum, an institution's economic interest in the policy should be equal to the premiums paid plus a reasonable rate of return, defined as a rate of return that is comparable to returns on investments of similar maturity and credit risk.

Split-dollar life insurance has complex tax and legal consequences. An institution considering entering into a split-dollar life insurance arrangement should consult qualified tax, legal, and insurance advisers.

Step 7—Analyze the associated risks and the ability to monitor and respond to those risks. An institution's pre-purchase analysis should include a thorough evaluation of all significant risks, as well as management's ability to identify, measure, monitor, and control those risks. An explanation of key risks (liquidity, transaction/operational, reputation, credit, interest rate, compliance/legal, and price) is included in the "Risk Management of BOLI" section of this interagency statement.

Step 8—Evaluate the alternatives. Regardless of the purpose of BOLI, a comprehensive pre-purchase analysis will include an analysis of available alternatives. Prior to acquiring BOLI, an institution should thoroughly analyze the risks and benefits, compared to alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation, as appropriate.

7. A 1035 exchange is a tax-free replacement of an insurance policy for another insurance contract covering the same person in accordance with section 1035 of the Internal Revenue Code.

8. For national banks, appendix A to 12 CFR 30; for state member banks, appendix D-1 to 12 CFR 208; for insured state nonmember banks, appendix A to 12 CFR 364; for savings associations, appendix A to 12 CFR 570.

Step 9—Document the decision. A well-managed institution maintains adequate documentation supporting its comprehensive pre-purchase analysis, including an analysis of both the types and design of products purchased and the overall level of BOLI holdings.

Risk Management of BOLI

Risk assessment and risk management are vital components of an effective BOLI program. In addition to conducting a risk assessment as part of a thorough pre-purchase analysis, monitoring BOLI risks on an ongoing basis is important, especially for an institution whose aggregate BOLI holdings represent a capital concentration. Management of an institution should review the performance of the institution's insurance assets with its board of directors at least annually. More-frequent reviews are appropriate if there are significant anticipated changes to the BOLI program such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI. This risk-management review should include, but not necessarily be limited to:

- *Comprehensive assessment of the specific risks discussed in this section.*[9]
- *Identification of which employees are, or will be, insured (e.g., vice presidents and above, employees of a certain grade level).* For example, an institution that acquires another institution that owns BOLI may acquire insurance on individuals that it would not insure under its own standards. While the acquiring institution need not correct such exceptions, it is important to know that such exceptions exist.
- *Assessment of death benefit amounts relative to employee salaries.* Such information helps management to assess the reputation and insurable interest risks associated with disproportionately large death benefits.
- *Calculation of the percentage of insured persons still employed by the institution.* Larger institutions often find that their policies insure more former employees than current employees. This information can help the institution assess reputation risk.
- *Evaluation of the material changes to BOLI risk-management policies.*
- *Assessment of the effects of policy exchanges.* Exchanges typically are costly and it is a sound practice to review the costs and benefits of such actions.
- *Analysis of mortality performance and impact on income.* Material gains from death benefits can create reputation risks.
- *Evaluation of material findings from internal and external audits and independent risk-management reviews.*
- *Identification of the reason for, and tax implications of, any policy surrenders.* In some cases, institutions have surrendered BOLI policies and incurred tax liabilities and penalties. Formal assessment of the costs and benefits of a surrender is a useful component of sound corporate governance.
- *Peer analysis of BOLI holdings.* To address reputation risk, an institution should compare its BOLI holdings relative to capital to the holdings of its peers to assess whether it is an outlier.

Liquidity Risk

Liquidity risk is the risk to earnings and capital arising from an institution's inability to meet its obligations when they come due without incurring unacceptable losses. Before purchasing permanent insurance, management should recognize the illiquid nature of the product and ensure that the institution has the long-term financial flexibility to hold the asset in accordance with its expected use. The inability to hold the life insurance until the death(s) of the insured(s) when the death benefits will be collected may compromise the success of the BOLI plan. An institution generally does not receive any cash flow from the insurance until the death benefit is paid. Depending upon the age of the insured population, it is possible that an institution that insures a small number of employees may not recognize any cash flow from the insurance for many years. The illiquid nature of insurance assets, combined with the difficulty of projecting liquidity needs far into the future, is a major reason an institution should keep its BOLI holdings below the agencies' concentration

9. All of the risks discussed in this section are applicable to permanent insurance. In contrast, because temporary insurance does not have a savings component or a CSV, it does not expose an institution to liquidity, interest-rate, or price risk. These risks need not be evaluated in the comprehensive assessment of the risks of temporary insurance.

guidelines. Examiners will consider an institution's BOLI holdings when assessing liquidity and assigning the liquidity component rating.

The purchase of BOLI may negatively affect an institution's liquidity position, both because BOLI is one of the least liquid assets on an institution's balance sheet, and because institutions normally fund BOLI purchases through the sale of liquid assets (e.g., marketable securities). To access the CSV of BOLI, the institution must either surrender or borrow against the policy. In accordance with the policy contract and federal tax laws, the surrender of a policy may subject an institution to surrender charges, tax liabilities for previously untaxed increases in the CSV, and tax penalties. Borrowing against the CSV is disadvantageous in most cases due to limitations on the ability to deduct interest on the borrowing and other possible adverse tax consequences.

A BOLI product qualifying as a modified endowment contract (MEC) for tax purposes has particular liquidity disadvantages. If an institution surrenders a MEC, it will incur a tax liability on the increase in the policy's CSV from earnings on the policy since its inception and may incur an additional tax penalty for early surrender.

In order to avoid such additional tax penalties, an institution may opt to purchase a non-MEC contract. A non-MEC contract permits the policy owner to surrender the policy without incurring the additional tax penalty that, under certain circumstances, applies to MECs. Moreover, depending on the terms of the insurance contract, an institution generally may withdraw up to the basis (that is, the original amount invested) without creating a taxable event. However, a non-MEC policy increases in complexity if it is in the form of a separate account covered by a stable value protection (SVP) contract. An SVP contract protects the policy owner from declines in the value of the assets in the separate account arising from changes in interest rates, thereby mitigating price risk and earnings volatility. An SVP contract is most often used in connection with fixed-income investments. Institutions should recognize that SVP providers often place restrictions on the amount that may be withdrawn from the separate account, thereby reducing the liquidity of the BOLI asset. An institution considering the purchase of a non-MEC for its potential liquidity advantages compared to a MEC also should be aware of contractual provisions, such as 1035 exchange fees and "crawl-out" restrictions,[10] which may limit such advantages.

Transaction/Operational Risk

As it applies to BOLI, transaction/operational risk is the risk to earnings and capital arising from problems caused by the institution's failure to fully understand or to properly implement a transaction. Transaction/operational risk arises due to the variety and complexity of life insurance products, as well as tax and accounting treatments. To help mitigate this risk, management should have a thorough understanding of how the insurance product works and the variables that dictate the product's performance. The variables most likely to affect product performance are the policy's interest-crediting rate, mortality cost, and other expense charges.

Transaction/operational risk is also a function of the type and design features of a life insurance contract. With a general-account product, there are only two parties to the contract: the policy owner and the insurance carrier. With a separate-account product, the insurance carrier has a separate contract with an investment manager. There could also be an SVP provider with whom the carrier has a separate contract.

Transaction/operational risk may also arise as a result of the variety of negotiable features associated with a separate-account product. These include the investment options; the terms, conditions, and cost of SVP; and mortality options. Deferred acquisition costs (DAC) represent the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs and capitalizes the DAC, including the prepayment of taxes in accordance with federal tax law. As the carrier recovers the DAC in accordance with applicable tax law, it credits the amount to the separate-account policyholder. Once it has been credited to the institution, the DAC is essentially a receivable from the carrier and, therefore, represents a general-account credit exposure.

Separate-account policies have additional transaction risks that can result from accounting requirements. Several institutions have had to

10. A crawl-out restriction limits the amount of CSV eligible for a 1035 exchange or surrender over a period of time.

restate their earnings because of contractual provisions in their policies that were ambiguous with respect to the amount of the CSV available upon surrender of the policy. Because BOLI must be carried at the amount that could be realized under the insurance contract as of the balance-sheet date, if any contractual provision related to costs, charges, or reserves creates uncertainty regarding the realization of a policy's full CSV, the agencies will require an institution to record the BOLI net of those amounts. As part of an effective pre-purchase analysis, an institution should thoroughly review and understand how the accounting rules will apply to the BOLI policy it is considering purchasing.

Tax and Insurable Interest Implications

Before the purchase of BOLI and periodically thereafter, management should also explicitly consider the financial impact (e.g., tax provisions and penalties) of surrendering a policy. Recent adverse press coverage of corporate-owned life insurance (COLI) should serve as a reminder to institutions that the current tax law framework, as it applies to BOLI, is always subject to legislative changes. A tax change that makes future BOLI cash flows subject to income tax, while perhaps deemed unlikely by many institutions, would have a negative impact on the economics of the BOLI holdings. An institution should recognize that earnings from BOLI could make it subject to the alternative minimum tax.

Institutions should also recognize that their actions, subsequent to purchase, could jeopardize the tax-advantaged status of their insurance holdings. The risk that a life insurance policy could be characterized by the Internal Revenue Service (IRS) as an actively managed investment is particularly relevant to separate-account policies. Many larger institutions prefer separate-account products because of perceived lower credit risk and greater transparency (that is, explicit disclosure of costs). Assets held by the insurance company on behalf of the policy owners in the separate account are intended to be beyond the reach of the insurance company's general creditors in the event of insolvency; however, the protected status of separate-account assets is generally untested in the courts. While the separate-account structure helps to mitigate an institution's credit exposure to the insurance carrier, the institution can have no "control" over investment decisions (e.g., timing of investments or credit selection) in the underlying account. Generally, allocating separate-account holdings across various divisions of an insurance company's portfolio does not raise concerns about "control," but other actions that a policy owner takes may be construed as investment control and could jeopardize the tax-advantaged status.

To benefit from the favorable tax treatment of insurance, a BOLI policy must be a valid insurance contract under applicable state law and must qualify under applicable federal law. Institutions must have an insurable interest in the covered employee, as set forth in applicable state laws. Furthermore, the favorable tax-equivalent yields of BOLI result only when an institution generates taxable income. Institutions that have no federal income tax liability receive only the nominal interest-crediting rate as a yield. In such an environment, BOLI loses much of its yield advantage relative to other investment alternatives.

Some institutions seem to have drawn comfort from assurances from insurance carriers that the carrier would waive lack of insurable interest as a defense against paying a claim. While the carrier may indeed make a payment, such payment may not necessarily go to the institution. Such assurances may not be sufficient to satisfy the IRS requirements for a valid insurance contract, nor do they eliminate potential claims from the estate of the insured that might seek to claim insurance proceeds on the basis that the institution lacked an insurable interest.

For example, some institutions have established out-of-state trusts to hold their BOLI assets. While such trusts may have legitimate uses, such as to gain access to an insurance carrier's product, in some cases the purpose is to avoid unfavorable insurable interest laws in the institution's home state and to domicile the policy in a state with more lenient requirements. In some cases, institutions have not made employees aware that they have taken out insurance on their lives.

A recent Fifth Circuit Court of Appeals ruling demonstrates the potential danger of this approach. A Texas employer used a Georgia trust to hold life insurance policies on its employees in Texas, and the trust agreement provided that the insurable interest law of Georgia should apply. In a lawsuit brought by the estate of a deceased employee, the court ignored this provision because the insured employee was not a party to the trust agreement. It then found that the insurable interest law of Texas applied and under that state's law, the employer did not have an insurable interest in the employee. The result was that the employer was not entitled to the insurance death benefits.[11] The outcome in this case suggests that institutions that have used, or are considering using, an out-of-state trust to take advantage of more-favorable insurable interest laws in another state should assess whether they could be vulnerable to a similar legal challenge.

Institutions should have appropriate legal review to help ensure compliance with applicable tax laws and state insurable interest requirements. Institutions that insure employees for excessive amounts may be engaging in impermissible speculation or unsafe and unsound banking practices. The agencies may require institutions to surrender such policies.

Reputation Risk

Reputation risk is the risk to earnings and capital arising from negative publicity regarding an institution's business practices. While this risk arises from virtually all bank products and services, reputation risk is particularly prevalent in BOLI because of the potential perception issues associated with an institution's owning or benefiting from life insurance on employees.

A well-managed institution will take steps to reduce the reputation risk that may arise as a result of its BOLI purchases, including maintaining appropriate documentation evidencing informed consent by the employee, prior to purchasing insurance. Some institutions assert that they make employees aware via employee handbooks, manuals, or newsletters of the possibility that the institution may acquire life insurance on them. Although such disclosure may satisfy state insurance requirements, any approach that does not require formal employee consent may significantly increase an institution's reputation risk.

Some institutions have begun to purchase separate-account, non-MEC product designs in order to address the liquidity concerns with MEC policies. One consequence of this product design choice, however, is that it has become increasingly common for institutions to insure a very large segment of their employee base, including non-officers. Because non-MEC designs have a higher ratio of death benefit to premium dollar invested, some institutions have, therefore, taken out very high death benefit policies on employees, including lower-level employees, further adding to reputation risk and highlighting the importance of obtaining explicit consent.

Credit Risk

Credit risk is the potential impact on earnings and capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise perform as agreed. All life insurance policyholders are exposed to credit risk. The credit quality of the insurance company and duration of the contract are key variables. With insurance, credit risk arises from the insurance carrier's contractual obligation to pay death benefits upon the death of the insured, and if applicable, from the carrier's obligation to pay the CSV (less any applicable surrender charges) upon the surrender of the policy.

Most BOLI products have very long-term (30- to 40-year) expected time frames for full collection of cash proceeds, i.e., the death benefit. For general-account policies, the CSV is an unsecured, long-term, and nonamortizing obligation of the insurance carrier. Institutions record and carry this claim against the insurance company as an asset.

Before purchasing BOLI, an institution should conduct an independent financial analysis of the insurance company and continue to monitor its condition on an ongoing basis. The institution's credit-risk-management function should participate in the review and approval of insurance carriers. As with lending, the depth and frequency of credit analysis (both initially and on an ongoing basis) should be a function of the relative size and complexity of the transaction and the size of outstanding exposures. Among other things, an institution should consider its legal lending limit, concentration guidelines (generally defined as the aggregate of direct, indirect, and contingent obligations and exposures that exceed 25 percent of the institution's capital), and any applicable state restrictions on BOLI holdings when assessing its broader credit-risk exposure to insurance carriers. To measure

11. Mayo v. Hartford Life Insurance Company, 354 F.3d 400 (5th Cir. 2004).

credit exposures comprehensively, an institution should aggregate its exposures to individual insurance carriers, and the insurance industry as a whole, attributable to both BOLI policies and other credit relationships (e.g., loans and derivatives exposures).

There are product design features of a BOLI policy that can reduce credit risk. As noted earlier, an institution can purchase separate-account products, where the institution assumes the credit risk of the assets held in the separate account, rather than the direct credit risk of the carrier as would be the case in a general-account policy. With separate-account policies, the insurance carrier owns the assets, but maintains the assets beyond the reach of general creditors in the event of the insurer's insolvency. However, even with a separate-account policy, the policy owner incurs some general-account credit-risk exposure to the insurance carrier associated with the carrier's mortality and DAC reserves. Amounts equal to the mortality and DAC reserves are owed to the policyholder and represent general-account obligations of the insurance carrier. In addition, the difference, if any, between the CSV and the minimum guaranteed death benefit would be paid out of the insurance carrier's general account.

A separate-account policy may have a stable value protection (SVP) contract issued by the insurance carrier or by a third party that is intended to protect the policyholder from most declines in fair value of separate-account assets. In general, the provider of an SVP contract agrees to pay any shortfall between the fair value of the separate-account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. Under most arrangements, the insurance carrier is not responsible for making a payment under the SVP contract if a third-party protection provider fails to make a required payment to it. The SVP contract thus represents an additional source of credit risk for a separate-account product. The policyholder's exposure under an SVP contract is to both the protection provider, which must make any required payment to the insurance carrier, and the carrier, which must remit the payment received from the protection provider to the institution. Because of this exposure, an institution should also evaluate the repayment capacity of the SVP provider.

State insurance regulation governing reserve requirements for insurance carriers, state guaranty funds, and reinsurance arrangements help to reduce direct credit risks from general-account exposures. Further, an institution can use a 1035 exchange to exit a deteriorating credit exposure, although most policies impose fees for the exchange. While credit risk for existing general- and separate-account policies may be low currently, the extremely long-term nature of a BOLI policy underscores the fact that credit risk remains an important risk associated with life insurance products. Strong current credit ratings offer no guarantee of strong credit ratings 20, 30, or 40 years into the future.

Interest-Rate Risk

Interest-rate risk is the risk to earnings and capital arising from movements in interest rates. Due to the interest-rate risk inherent in general-account products, it is particularly important that management fully understand how these products expose the policyholder to interest-rate risk before purchasing the policy. The interest-rate risk associated with these products is primarily a function of the maturities of the assets in the carrier's investment portfolio, which often range from four to eight years. When purchasing a general-account policy, an institution chooses one of a number of interest-crediting options (that is, the method by which the carrier will increase the policy's CSV). Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the carrier's portfolio each year. Using the "new money" crediting rate, the institution earns a return based upon yields available in the market at the time it purchases the policy.

Separate-account products may also expose the institution to interest-rate risk, depending on the types of assets held in the separate account. For example, if the separate-account assets consist solely of U.S. Treasury securities, the institution is exposed to interest-rate risk in the same way as holding U.S. Treasury securities directly in its investment portfolio. However, because the institution cannot control the separate-account assets, it is more difficult for the institution to control this risk. Accordingly, before purchasing a separate-account product, an institution's management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent within the separate account and ensure that the risk is appropriate for the institution. The institution also should establish monitoring and reporting systems that will enable management to monitor and respond to interest-rate fluctuations and their effect on separate-account assets.

Compliance/Legal Risk

Compliance/legal risk is the risk to earnings and capital arising from violations of, or nonconformance with, laws, rulings, regulations, prescribed practices, or ethical standards. Failure to comply with applicable laws, rulings, regulations, and prescribed practices could compromise the success of a BOLI program and result in fines or penalties imposed by regulatory authorities or loss of tax benefits. Among the legal and regulatory considerations that an institution should evaluate are compliance with state insurable interest laws, the Employee Retirement Income Security Act of 1974 (ERISA), Federal Reserve Regulations O and W (12 CFR 215 and 223, respectively), the Interagency Guidelines Establishing Standards for Safety and Soundness, the requirements set forth under the "Legal Authority" section of this document, and federal tax regulations applicable to BOLI.

Tax benefits are critical to the success of most BOLI plans. Accordingly, an institution owning separate-account BOLI must implement internal policies and procedures to ensure that it does not take any action that might be interpreted as exercising "control" over separate-account assets. This is especially important for privately placed policies in which the institution is the only policyholder associated with the separate-account assets.

When purchasing BOLI, institutions should be aware that the splitting of commissions between a vendor and the institution's own subsidiary or affiliate insurance agency presents compliance risk. The laws of most states prohibit the payment of inducements or rebates to a person as an incentive for that person to purchase insurance. These laws may also apply to the person receiving the payment. When an insurance vendor splits its commission with an institution's insurance agency that was not otherwise involved in the transaction, such a payment may constitute a prohibited inducement or rebate. Accordingly, an institution should assure itself that this practice is permissible under applicable state law and in compliance with Federal Reserve Regulation W before participating in any such arrangement. Moreover, payments to an affiliate that did not perform services for the institution could also raise other regulatory and supervisory issues.

Due to the significance of the compliance risk, institutions should seek the advice of counsel on these legal and regulatory issues.

Price Risk

Price risk is the risk to earnings and capital arising from changes in the value of portfolios of financial instruments. Accounting rules permit owners of insurance contracts to account for general-account products using an approach that is essentially based on cost plus accrued earnings. However, for separate-account products without SVP, the accounting would largely be based on the fair value of the assets held in the account because this value is the amount that could be realized from the separate account if the policy is surrendered. (See "Accounting Considerations" above.) Typically, the policyholder of separate-account products assumes all price risk associated with the investments within the separate account. Usually, the insurance carrier will provide neither a minimum CSV nor a guaranteed interest-crediting rate for separate-account products. Absent an SVP contract, the amount of price risk generally depends upon the type of assets held in the separate account.

Because the institution does not control the separate-account assets, it is more difficult for it to control the price risk of these assets than if they were directly owned. To address income-statement volatility, an institution may purchase an SVP contract for its separate-account policy. The SVP contract is designed to ensure that the amount that an institution could realize from its separate-account policy, in most circumstances, remains at or above the cost basis of the separate account to the policyholder. Institutions should understand, however, that SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk. Moreover, one purpose of the SVP contract is to reduce volatility in an institution's reported earnings. To realize any economic benefit of the SVP contract, an institution would have to surrender the policy. Since policy surrender is nearly always an uneconomic decision, the SVP contract provides, in a practical sense, accounting benefits only.

Before purchasing a separate-account life insurance product, management should thoroughly review and understand the instruments governing the investment policy and management of the separate account. Management should understand the risk inherent in the separate account and ensure that the risk is appropriate. If the institution does not purchase SVP, management should establish monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of separate-account assets.

Under limited circumstances it is legally permissible for an institution to purchase an equity-linked variable life insurance policy if the policy is an effective economic hedge against the institution's equity-linked obligations under employee benefit plans.[12] An effective economic hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instrument. Such a relationship would exist where the obligation under an institution's deferred compensation plan is based upon the value of a stock market index and the separate account contains a stock mutual fund that mirrors the performance of that index. Institutions need to be aware that this economic hedge may not qualify as a hedge for accounting purposes. Thus, the use of equity-linked variable life insurance policies to economically hedge equity-linked obligations may not have a neutral effect on an institution's reported earnings.

Unlike separate-account holdings of debt securities, SVP contracts on separate-account equity holdings are not common. The economic hedging criteria for equity-linked insurance products lessen the effect of price risk because changes in the amount of the institution's equity-linked liability are required to offset changes in the value of the separate-account assets. If the insurance cannot be characterized as an effective economic hedge, the presence of equity securities in a separate account is impermissible, and the agencies will require institutions to reallocate the assets unless retention of the policy is permitted under federal law.[13]

In addition to the general considerations discussed previously, which are applicable to any separate-account product, an institution should perform further analysis when purchasing a separate-account product involving equity securities. At a minimum, the institution should:

1. Compare the equity-linked liability being hedged (e.g., deferred compensation) and the equity securities in the separate account. Such an analysis considers the correlation between the liability and the equity securities, expected returns for the securities (including standard deviation of returns), and current and projected asset and liability balances.
2. Determine a target range for the hedge effectiveness ratio (e.g., 95 to 105 percent) and establish a method for measuring hedge effectiveness on an ongoing basis. The institution should establish a process for altering the program if hedge effectiveness drops below acceptable levels. Consideration should be given to the potential costs of program changes.
3. Establish a process for analyzing and reporting to management and the board the effect of the hedge on the institution's earnings and capital ratios. The analysis usually considers results both with and without the hedging transaction.

Risk-Based Capital Treatment

If an institution owns a general-account insurance product, it should apply a 100 percent risk weight to its claim on the insurance company for risk-based capital purposes. A BOLI investment in a separate-account insurance product, however, may expose the institution to the market and credit risks associated with the pools of assets in the separate account. The assets in a pool may have different risk weights, similar to the assets held in a mutual fund in which an institution has invested. For risk-based capital purposes, if an institution can demonstrate that the BOLI separate-account policy meets the requirements below, it may choose to "look through" to the underlying assets to determine the risk weight.

12. Insured state banks and state savings associations may make such purchases only if permitted to do so under applicable state law.

13. Insured state banks and state savings associations may request the FDIC's consent to retain the policies, but consent will not be granted if it is determined that retaining the policies presents a significant risk to the appropriate insurance fund.

Criteria for a Look-Through Approach

To qualify for the "look-through" approach, separate-account BOLI assets must be protected from the insurance company's general creditors in the event of the insurer's insolvency. An institution should document its assessment, based upon applicable state insurance laws and other relevant factors, that the separate-account assets would be protected from the carrier's general creditors. If the institution does not have sufficient information to determine that a BOLI separate-account policy qualifies for the look-through approach, the institution must apply the standard risk weight of 100 percent to this asset.

In addition, when an institution has a separate-account policy, the portion of the carrying value of the institution's insurance asset that represents general-account claims on the insurer, such as deferred acquisition costs (DAC) and mortality reserves that are realizable as of the balance-sheet date, and any portion of the carrying value attributable to an SVP contract, are not eligible for the look-through approach. These amounts should be risk-weighted at the 100 percent risk weight applicable to claims on the insurer or the SVP provider, as appropriate.

Look-Through Approaches

When risk-weighting a qualifying separate-account policy, an institution may apply the highest risk weight for an asset permitted in theseparate account, as stated in the investment agreement, to the entire carrying value of the separate-account policy, except for any portions of the carrying value that are general-account claims or are attributable to SVP. In no case, however, may the risk weight for the carrying value of the policy (excluding any general-account and SVP portions) be less than 20 percent.

Alternatively, an institution may use a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy (excluding any general-account and SVP portions). The pro rata approach is based on the investment limits stated in the investment agreement for each class of assets that can be held in the separate account, with the constraint that the weighted average risk weight may not be less than 20 percent. If the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, the institution must use the highest risk weight for the maximum amount permitted in that asset class, and then proceed to the next-highest risk weight until the permitted amounts equal 100 percent.

For example, if a separate-account investment agreement permits a maximum allocation of 60 percent for corporate bonds, 40 percent for U.S. government–sponsored enterprise debt securities, and 60 percent for U.S. Treasury securities, then the institution must risk-weight 60 percent of the carrying value of the separate-account investment (excluding any portion attributable to SVP) at the 100 percent risk weight applicable to corporate bonds and the remaining 40 percent at the 20 percent risk weight for U.S. government–sponsored enterprise debt securities. Because the sum of the permitted allocation for corporate bonds and government-sponsored enterprise debt securities totals 100 percent, the institution cannot use the zero percent risk weight for U.S. Treasury securities. However, if the permitted allocation for U.S. government–sponsored enterprise debt securities was 30 percent rather than 40 percent, the institution could risk-weight the remaining 10 percent of the carrying value of its investment at the zero percent risk weight for U.S. Treasuries.

Regardless of the look-through approach an institution employs, the weighted average risk weight for the separate-account policy (excluding any general-account and SVP portions) may not be less than 20 percent, even if all the assets in the separate account would otherwise qualifyfor a zero percent risk weight. Furthermore, the portion of the carrying value of the separate-account policy that represents general-account claims on the insurer, such as realizable DAC and mortality reserves, and any portion of the carrying value attributable to an SVP contract, should be risk-weighted at the risk weight applicable to the insurer or the SVP provider, as appropriate.

The following example demonstrates the appropriate risk-weight calculations for the pro rata approach, incorporating the components of a BOLI separate-account policy that includes general-account claims on the insurer as well as the investment allocations permitted for different asset classes in the separate-account investment agreement.

Example. The separate-account investment agreement requires the account to hold a minimum of

10 percent in U.S. Treasury obligations. It also imposes a maximum allocation of 50 percent in mortgage-backed securities issued by U.S. government–sponsored enterprises, and a maximum allocation of 50 percent in corporate bonds.

Assume that the portion of the carrying value of the separate-account policy attributable to realizable DAC and mortality reserves equals $10 and that the portion attributable to the SVP totals $10.

Carrying value of separate-account policy	$100.00
Less: Portion attributable to DAC and mortality reserves	10.00
Portion attributable to SVP	10.00
Net carrying value of separate-account policy available for pro rata	$ 80.00
Risk-weight calculation:	
U.S. Treasury @ 10% x $80 = $8 x 0% RW	0.00
Corporate bonds @ 50% x $80 = $40 x 100% RW	$ 40.00
GSE MBS @ 40% x $80 = $32 x 20% RW	6.40
Separate-account risk-weighted assets subject to pro rata	$ 46.40
Add back: DAC and mortality reserves = $10 x 100% RW	$ 10.00
Add back: SVP = $10 x 100% RW	10.00
General-account and SVP risk-weighted assets	$ 20.00
Total BOLI-related risk-weighted assets	$ 66.40

Summary

The purchase of BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits. Consistent with safe and sound banking practices, institutions must understand the risks associated with this product and implement a risk-management process that provides for the identification and control of such risks. A sound pre-purchase analysis, meaningful ongoing monitoring program, reliable accounting process, and accurate assessment of risk-based capital requirements are all components of the type of risk-management process the agencies expect institutions to employ.

Where an institution has acquired BOLI in an amount that approaches or exceeds agency concentration levels, examiners will more closely scrutinize the components of the risk-management process and the institution's associated documentation. Where BOLI has been purchased in an impermissible manner, ineffective controls over BOLI risks exist, or a BOLI exposure poses a safety-and-soundness concern, the appropriate agency may take supervisory action, including requiring the institution to divest affected policies, irrespective of tax consequences.

Appendix A—Common Types of Life Insurance

Life insurance can be categorized into two broad types: temporary (also called "term") insurance and permanent insurance. There are numerous variations of these products. However, most life insurance policies fall within one (or a combination) of the following categories.

Temporary (Term) Insurance

Temporary (term) insurance provides life insurance protection for a specified time period. Death benefits are payable only if the insured dies during the specified period. If a loss does not occur during the specified term, the policy lapses and provides no further protection. Term insurance premiums do not have a savings component; thus, term insurance does not create cash surrender value (CSV).

Permanent Insurance

In contrast to term insurance, permanent insurance is intended to provide life insurance protection for the entire life of the insured, and its premium structure includes a savings component. Permanent insurance policy premiums typically have two components: the insurance component (e.g., mortality cost, administrative fees, and sales loads) and the savings component. Mortality cost represents the cost imposed on the policyholder by the insurance company to cover the amount of pure insurance protection for which the insurance company is at risk.

The savings component typically is referred to as CSV. The policyholder may use the CSV to make the minimum premium payments necessary to maintain the death benefit protection and may access the CSV by taking out loans or making partial surrenders. If permanent insurance is surrendered before death, surrender charges may be assessed against the CSV. Generally, surrender charges are assessed if the policy is surrendered within the first 10 to 15 years.

Two broad categories of permanent insurance are:

- *Whole life.* A traditional form of permanent insurance designed so that fixed premiums are paid for the entire life of the insured. Death benefit protection is provided for the entire life of the insured, assuming all premiums are paid.
- *Universal life.* A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a very high CSV. Alternatively, the policyholder can make minimal payments in an amount just large enough to cover mortality and other insurance charges.

Purposes for Which Institutions Commonly Purchase Life Insurance

Key person. Institutions often purchase life insurance to protect against the loss of "key persons" whose services are essential to the continuing success of the institution and whose untimely death would be disruptive. For example, an institution may purchase insurance on the life of an employee or director whose death would be of such consequence to the institution as to give it an insurable interest in his or her life. The determination of whether an individual is a key person does not turn on that individual's status as an officer or director, but on the nature of the individual's economic contribution to the institution.

The first step in indemnifying an institution against the loss of a key person is to identify the key person. The next and possibly most difficult step is estimating the insurable value of the key person or the potential loss of income or other value that the institution may incur from the untimely death of that person.

Because the most appropriate method for determining the value of a key person is dependent upon individual circumstances, the agencies have not established a formula or a specific process for estimating the value of a key person. Instead, the agencies expect institutions to consider and analyze all relevant factors and use their judgment to make a decision about the value of key persons.

Key-person life insurance should not be used in place of, and does not diminish the need for, adequate management-succession planning. Indeed, if an institution has an adequate management-succession plan, its reliance on a key person should decline as the person gets closer to retirement.

Financing or cost recovery for benefit plans. Like other businesses, institutions often use life insurance as a financing or cost-recovery vehicle for pre- and post-retirement employee benefits, such as individual or group life insurance, health insurance, dental insurance, vision insurance, tuition reimbursement, deferred compensation, and pension benefits.

Permanent insurance is used for this purpose. In these arrangements, an institution insures the lives of directors or employees in whom it has an insurable interest to reimburse the institution for the cost of employee benefits. The group of insured individuals may be different from the group that receives benefits. The institution's obligation to provide employee benefits is separate and distinct from the purchase of the life insurance. The life insurance purchased by the institution remains an asset even after the employer's relationship with an insured employee is terminated. The employees who receive benefits, whether insured or not, have no ownership interest in the insurance (other than their general claim against the institution's assets arising from the institution's obligation to provide the stated employee benefits).

There are two common methods of financing employee benefits through the purchase of life insurance. The first is the cost-recovery method, which usually involves present-value analysis. Typically, the institution projects the amount of the expected benefits owed to employees and then discounts this amount to determine the present value of the benefits. Then, the institution purchases a sufficient amount of life insurance on the lives of certain employees so that the gain (present value of the life insurance proceeds less the premium payments) from the insurance proceeds reimburses the institution for the benefit payments. Under this method, the institution absorbs the cost of providing the employee benefits and the cost of purchasing the life insurance. The institution holds the life insurance and collects the death benefit to reimburse the institution for the cost of the employee benefits and the insurance.

The second method of financing employee benefits is known as cost offset. With this method, the institution projects the annual employee benefit expense associated with the benefit plan. Then, the institution purchases life insurance on the lives of certain employees. The amount earned on the CSV each year should not exceed the annual benefit expense.

Split-dollar life insurance arrangements. Institutions sometimes use split-dollar life insurance arrangements to provide retirement benefits and death benefits to certain employees as part of their compensation. Under split-dollar arrangements, the employer and the employee share the rights to the policy's CSV and death benefits. The employer and the employee may also share premium payments. If the employer pays the entire premium, the employee may need to recognize taxable income each year in accordance with federal income tax regulations.

Split-dollar arrangements may be structured in a number of ways. The two most common types of split-dollar arrangements are:

- *Endorsement split-dollar.* The employer owns the policy and controls all rights of ownership. The employer provides the employee an endorsement of the portion of the death benefit specified in the plan agreement with the employee. The employee may designate a beneficiary for the designated portion of the death benefit. Under this arrangement, the employer typically holds the policy until the employee's death. At that time, the employee's beneficiary receives the designated portion of the death benefits, and the employer receives the remainder of the death benefits.
- *Collateral-assignment split-dollar.* The employee owns the policy and controls all rights of ownership. Under these arrangements, the employer usually pays the entire premium or a substantial part of the premium. The employee assigns a collateral interest in the policy to the employer that is equal to the employer's interest in the policy. The employer's interest in the policy is set forth in the split-dollar agreement between the employer and the employee. Upon retirement, the employee may have an option to buy the employer's interest in the insurance policy. This transfer of the employer's interest to the employee is typically referred to as a "roll-out." If a "roll-out" is not provided or exercised, the employer does not receive its interest in the policy until the employee's death.

Split-dollar life insurance is a very complex subject that can have unforeseen tax and legal consequences. Internal Revenue Service regulations issued in 2003[14] govern the taxation of split-dollar life insurance arrangements entered into or materially modified after September 17, 2003.[15] These rules provide less favorable tax treatment to split-dollar arrangements than existed previously. Institutions considering entering into a split-dollar life insurance arrangement should consult qualified tax, insurance, and legal advisers.

Life insurance on borrowers. State law generally recognizes that a lender has an insurable interest in the life of a borrower to the extent of the borrower's obligation to the lender. In some states, the lender's insurable interest may equal the borrower's obligation plus the cost of insurance and the time value of money. Institutions are permitted to protect themselves against the

14. 68 *Fed. Reg.* 54336 (Sept. 17, 2003), chiefly codified at 26 CFR 1.61-22 and 1.7872-15.

15. Split-dollar arrangements entered into prior to September 17, 2003, and not materially modified thereafter may be treated differently.

risk of loss from the death of a borrower. This protection may be provided through self-insurance, the purchase of debt-cancellation contracts, or by the purchase of life insurance policies on borrowers.

Institutions can take two approaches in purchasing life insurance on borrowers. First, an institution can purchase life insurance on an individual borrower for the purpose of protecting the institution specifically against loss arising from that borrower's death. Second, an institution may purchase life insurance on borrowers in a homogeneous group of loans employing a cost-recovery technique similar to that used in conjunction with employee benefit plans. Under this method, the institution insures the group of borrowers for the purpose of protecting the institution from loss arising from the death of any borrower in the homogeneous pool. Examples of homogeneous pools of loans include consumer loans that have distinctly similar characteristics, such as automobile loans, credit card loans, and residential real estate mortgages.

When purchasing insurance on an individual borrower, an institution should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to structure the insurance policy in a manner consistent with the expected repayment of the borrower's loan. To accomplish this, management should estimate the risk of loss over the life of the loan and match the anticipated insurance proceeds to the risk of loss. Generally, the risk of loss will be closely related to the outstanding principal of the debt. The insurance policy should be structured so that the expected insurance proceeds never substantially exceed the risk of loss.

When purchasing life insurance on borrowers in a homogeneous pool of loans, an institution's management should, given the facts and circumstances known at the time of the insurance purchase, make a reasonable effort to match the insurance proceeds on an aggregate basis to the total outstanding loan balances. If allowed by state law, institutions may match the insurance proceeds to the outstanding loan balances plus the cost of insurance on either a present-value or future-value basis. This relationship should be maintained throughout the duration of the program.

The purchase of life insurance on a borrower is not an appropriate mechanism for effecting a recovery on an obligation that has been charged off, or is expected to be charged off, for reasons other than the borrower's death. In the case of a charged-off loan, the purchase of life insurance on the borrower does not protect the institution from a risk of loss since the loss has already occurred. Therefore, the institution does not need to purchase insurance. Acquiring insurance that an institution does not need may subject the institution to unwarranted risks, which would be an unsafe and unsound banking practice. In the case of a loan that the institution expects to charge off for reasons other than the borrower's death, the risk of loss is so pronounced that the purchase of life insurance by the institution at that time would be purely speculative and an unsafe and unsound banking practice.

Internal Revenue Code section 264(f) disallows a portion of an institution's interest deduction for debt incurred to purchase life insurance on borrowers. Institutions considering the purchase of insurance on borrowers should consult their tax advisers to determine the economic viability of this strategy.

Life insurance as security for loans. Institutions sometimes take an interest in an existing life insurance policy as security for a loan. Institutions also make loans to individuals to purchase life insurance, taking a security interest in the policy, a practice known as "insurance-premium financing." As with any other type of lending, extensions of credit secured by life insurance should be made on terms that are consistent with safe and sound banking practices. For instance, the borrower should be obligated to repay the loan according to an appropriate amortization schedule.

Generally, an institution may not rely on its security interest in a life insurance policy to extend credit on terms that excuse the borrower from making interest and principal payments during the life of the borrower with the result that the institution is repaid only when the policy matures upon the death of the insured. Lending on such terms is generally speculative and an unsafe and unsound banking practice.

Institutions may acquire ownership of life insurance policies for debts previously contracted (DPC) by invoking their security interest in a policy after a borrower defaults. Consistent with safety and soundness, institutions should use their best efforts to surrender or otherwise dispose of permanent life insurance acquired for DPC at the earliest reasonable opportunity.[16] In

16. The OCC has generally directed national banks to

the case of temporary insurance acquired for DPC, retention until the next renewal date or the next premium date, whichever comes first, will be considered reasonable.

Appendix B—Glossary

Cash surrender value (CSV). The value available to the policyholder if the policy is surrendered. If no loans are outstanding, this amount is generally available in cash. If loans have been made, the amount available upon surrender is equal to the cash surrender value less the outstanding loan (including accrued interest).

Deferred acquisition costs (DAC). DAC represents the insurance carrier's up-front costs associated with issuing an insurance policy, including taxes and commissions and fees paid to agents for selling the policy. The carrier charges the policyholder for these costs. Carriers capitalize DAC and recover them in accordance with applicable tax law. As the carrier recovers DAC, it credits the amount to the policyholder.

Experience-rated pricing. A pricing method that bases prices for insurance products on the actual expenses and claims experience for the pool of individuals being insured.

General account. A design feature that is generally available to purchasers of whole or universal life insurance whereby the general assets of the insurance company support the policy's CSV.

Interest-crediting rate. The gross yield on the investment in the insurance policy, that is, the rate at which the cash value increases before considering any deductions for mortality cost, load charges, or other costs that are periodically charged against the policy's cash value.

There are a number of crediting rates, including "new money" and "portfolio." Using the "portfolio" crediting rate, the institution will earn a return based upon the existing yield of the insurance carrier's portfolio each year. Using the "new money" crediting rate, the institution will earn a return based upon yields available in the market at the time it purchases the policy.

surrender or divest permanent life insurance acquired for DPC within 90 days of obtaining control of the policy.

Modified endowment contract (MEC). Type of policy that is defined in Internal Revenue Code section 7702A. A MEC generally involves the payment of a single premium at the inception of the contract; thus, it fails the so-called seven-pay test set forth in the statute. MECs are denied some of the favorable tax treatment usually accorded to life insurance. For example, most distributions, including loans, are treated as taxable income. An additional 10 percent penalty tax also is imposed on distributions in some circumstances. However, death benefits remain tax-free.

Mortality charge. The pure cost of the life insurance death benefit within a policy. It represents a cost to the purchaser and an income item to the carrier. Mortality charges retained by the insurance carrier are used to pay claims.

Mortality reserve. In separate-account products, the mortality reserve represents funds held by an insurance carrier outside of the separate account to provide for the payment of death benefits.

Non-MEC. An insurance contract that is not categorized as a MEC under Internal Revenue Code section 7702A.

Separate account. A separate account is a design feature that is generally available to purchasers of whole life or universal life whereby the policyholder's CSV is supported by assets segregated from the general assets of the carrier. Under such an arrangement, the policyholder neither owns the underlying separate account nor controls investment decisions (e.g., timing of investments or credit selection) in the underlying separate account that is created by the insurance carrier on its behalf. Nevertheless, the policyholder assumes all investment and price risk.

Seven-pay test. The seven-pay test is a test set forth in Internal Revenue Code section 7702A that determines whether or not a life insurance product is a MEC for federal tax purposes.

Split-dollar life insurance. A split-dollar life insurance arrangement splits the policy's premium and policy benefits between two parties, usually an employer and employee. The two parties may share the premium costs while the policy is in effect, pursuant to a prearranged contractual agreement. At the death of the insured or the termination of the agreement, the parties split the policy benefits or proceeds in accordance with their agreement.

Stable value protection (SVP) contracts. In general, an SVP contract pays the policy owner of a separate account any shortfall between the fair value of the separate-account assets when the policy owner surrenders the policy and the cost basis of the separate account to the policy owner. The cost basis of the separate account typically would take into account the fair value of the assets in the account when the policy was initially purchased, the initial fair value of assets added to the account thereafter, interest credited to the account, the amount of certain redemptions and withdrawals from the account, and credit losses incurred on separate-account assets. Thus, SVP contracts mitigate price risk. SVP contracts are most often used in connection with fixed-income investments.

1035 exchange. A tax-free replacement of an insurance policy for another contract covering the same person(s) in accordance with section 1035 of the Internal Revenue Code.

Variable life insurance. Variable life insurance policies are investment-oriented life insurance policies that provide a return linked to an underlying portfolio of securities. The portfolio typically is a group of mutual funds chosen by the insurer and housed in a separate account, with the policyholder given some discretion in choosing among the available investment options.

Appendix C—Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance

The federal banking and thrift agencies developed responses to questions regarding the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance. A summary of these interpretations is included below to provide clarification on a wide variety of matters pertaining to financial reporting, credit-exposure limits, concentration limits, and the appropriate methodologies to use for calculating the amount of insurance an institution may purchase.

Legal Authority—State and Federal Law

As a general matter, the ability of state-chartered banks to purchase insurance (including equity-linked variable life insurance) is governed by state law. Section 24 of the Federal Deposit Insurance Act (the FDI Act) generally requires insured state-chartered banks to obtain the consent of the Federal Deposit Insurance Corporation (FDIC) before engaging as principal in activities (including making investments) that are not permissible for a national bank. Some state bank regulatory agencies have issued their own BOLI guidance or directives for their respective state-chartered institutions. A state-chartered institution should follow any BOLI guidance or directive issued by its state supervisory authority that is more restrictive than the interagency statement. Generally, if state law or policy is less restrictive than the interagency statement, a state-chartered institution should follow the interagency statement. If federal law is less restrictive than state law, a state-chartered institution should follow the state law.

Permissibility of Equity-Linked Securities in Separate-Account BOLI

The interagency statement states that national banks and federal savings associations may hold equity-linked variable life insurance policies (that is, insurance policies with a return tied to the performance of a portfolio of equity securities held in a separate account of the insurance company) only in very limited circumstances. Similarly, state member banks may also hold equity-linked variable life insurance policies only in very limited circumstances. Because the range of instruments with equity-like characteristics varies significantly, the permissibility of each such instrument must be analyzed on a case-by-case basis. Furthermore, the agencies have significant concerns regarding whether an institution properly understands the complex risk profile that securities with “equity-like” characteristics often present. Some securities, even if legally permissible, may be inappropriate for the vast majority of financial institutions, whether held in an investment portfolio or a separate-account BOLI product. The agencies’ April 1998 Supervisory Policy Statement on Investment Securities and End-User Derivatives

Activities provides guidance on the appropriateness of investments and risk-management expectations.

Senior Management and Board Oversight—Establishing BOLI Concentration Limits

Each institution should establish internal policies and procedures governing its BOLI holdings that limit the aggregate cash surrender value (CSV) of policies from any one insurance company as well as the aggregate CSV of policies from all insurance companies. The interagency statement is not intended to loosen the standards with respect to prior BOLI guidance. The agencies have rigorous expectations regarding the establishment of prudent limits and appropriate board and management oversight of the limit-setting process. Accordingly, exceptions will be subject to increased supervisory attention. The agencies continue to expect institutions to adopt per-carrier limits for BOLI, keeping in mind legal lending limits. Although the federal statutory and regulatory lending limits do not, as a general rule, impose a per-carrier legal constraint on BOLI because BOLI is not a loan, BOLI nevertheless does represent a long-term credit exposure. The agencies expect institutions to manage credit exposures in a prudent manner, irrespective of whether the exposure is subject to a statutory or regulatory limit. If an institution establishes an aggregate limit for BOLI based upon its applicable capital concentration threshold, it would seldom be prudent to have its per-carrier limit equal to the aggregate limit. Apart from credit considerations, it is also important to diversify BOLI exposures in order to control transaction risks that may be associated with an individual carrier's policies.

Per-Carrier Limits

Institutions should establish a per-carrier limit for separate-account policies. Diversification among carriers reduces transaction risks. Institutions should also explicitly consider whether it is appropriate to combine general- and separate-account exposures from the same carrier for purposes of measuring exposure against internal limits. The agencies believe that institutions, based upon their risk tolerance and understanding of insurance risks, should determine for themselves whether to combine such policies. In this regard, the agencies note that separate-account policies also present general-account credit exposures. For example, deferred acquisition costs (DAC) and mortality reserves associated with separate-account policies are general obligations of the insurance carrier. Moreover, when the death of an insured occurs, the difference between the death benefit amount and the cash surrender value comes from the carrier's general account. Finally, the actual credit exposure under a BOLI policy may be many times greater than the carrying value of the policy currently recorded on the institution's balance sheet, given the typical relationship between CSV and policy death benefits. Institutions should keep these factors in mind when evaluating whether and, if so, how to aggregate general- and separate-account exposures for purposes of monitoring compliance with internal limits.

Legal Limits and Concentrations

When establishing internal CSV limits, an institution should consider its legal lending limit, the capital concentration thresholds, and any applicable state restrictions on BOLI holdings. The following are the agencies' capital concentration definitions:

- The FDIC uses 25 percent of tier 1 capital to measure a capital concentration.
- The other agencies use tier 1 capital plus the allowance for loan and lease losses (ALLL).

A state-chartered institution should be guided by the more restrictive of the applicable state and federal limitations and thresholds. For example, if a state defines BOLI as an extension of credit subject to a statutory or regulatory lending limit, or otherwise imposes a per-carrier limit on BOLI, then institutions subject to that state's jurisdiction should ensure that their BOLI exposure to an individual carrier does not exceed the applicable state limit.

Permissibility of Holding Life Insurance on Former Employees and Former Key Persons

A well-managed institution adequately documents the purpose for which it is acquiring BOLI, as part of its pre-purchase analysis. When an institution purchases life insurance on a group of employees (whether it is a group policy or a series of individual policies) as a means to finance or recover the cost of employee benefits, and one or more of the insured employees is no longer employed by the bank, the insurance coverage may be retained by the institution provided—

- the application of the cost-recovery or cost-offset method (see "Quantifying the Amount of Insurance Appropriate for the Institution's Objectives" below) indicates that the amount of insurance held is not in excess of the amount required to recover or offset the cost of the institution's employee benefits,
- the policy is not specifically designated to cover only loss of income to the banking organization that may arise from the death of the employee,
- the coverage continues to qualify as an insurable interest under applicable state law, and
- the insurance asset continues to be a permissible holding under applicable state law for state-chartered institutions.

Additionally, if the policy no longer qualifies as insurance under the applicable state insurable-interest law, the policy may no longer be eligible for favorable tax treatment. These conditions apply to "benefits BOLI" despite the fact that the former employee was a "key person."

This is in contrast to true key-person insurance, in which the institution purchases life insurance on a key person in order to protect itself from financial loss in the event of that person's death. The interagency statement provides that a national bank or federal savings association may be required to surrender or otherwise dispose of key-person life insurance held on an individual who is no longer a key person because the institution will no longer suffer a financial loss from the death of that person. However, when an individual upon whom key-person life insurance has been held is no longer a key person, an institution may be able to recharacterize its objective for the insurance policy as recovery of the cost of providing employee benefits. In such cases, the institution must demonstrate, through appropriate analysis and quantification, that the insurance coverage satisfies the retention conditions, as set forth in the preceding paragraph. For a state-chartered institution, the recharacterization and retention of such key-person life insurance must be permissible under applicable state law. In circumstances where a national bank or federal savings association would be required to surrender or otherwise dispose of key-person life insurance, a state-chartered institution must also surrender or otherwise dispose of a key-person policy unless the retention of the policy is permitted under applicable state law and the institution obtains the FDIC's consent to continue to hold the policy under section 24 or section 28 of the FDI Act, as appropriate.

Quantifying the Amount of Insurance Appropriate for the Institution's Objectives

Institutions are responsible for ensuring that they do not purchase excessive amounts of insurance coverage on their employees relative to salaries paid and the costs of benefits to recover. Examiners will evaluate an institution's BOLI holdings and make a supervisory judgment as to whether insurance amounts on employees are so excessive as to constitute speculation or an unsafe or unsound practice on a case-by-case basis, as they do for other aspects of an institution's operations. Such an evaluation would be based on the totality of the circumstances.

Institutions may use either the cost-recovery or cost-offset method to quantify the amount of insurance permissible for purchase to finance or recover employee benefit costs. When using the cost-offset approach, an institution must ensure that the projected increase in CSV each year over the expected duration of the BOLI is less than or equal to the expected employee benefit expense for that year. When using the cost-recovery method, regardless of an institution's quantification method, management must be able to support, with objective evidence, the reasonableness of all assumptions used in determining the appropriate amount of insurance coverage needed, including the rationale for its discount rates (when the cost-recovery method is used) and cost projections.

Applicability of Prior Guidance for Split-Dollar Arrangements

The pre-purchase analysis guidance in the interagency statement applies to life insurance policies used in split-dollar arrangements that are acquired after December 7, 2004. The guidance concerning the ongoing risk management of life insurance after its purchase applies to life insurance policies, including those used in split-dollar arrangements, regardless of when acquired.

The FDIC's prior guidance on split-dollar arrangements, which was included in supervisory guidance on BOLI that was issued in 1993, has been superseded; until the issuance of the interagency statement, the FDIC had generally followed the Office of the Comptroller of the Currency's prior guidelines from 2000. Otherwise, the prior guidance issued by the agencies on split-dollar life insurance remains in effect. Each agency issued the interagency statement under its own bulletin, letter, or notice. For example, the Federal Reserve Board's issuance of the interagency statement is cross-referenced in SR-04-19, and the prior guidance on split-dollar life insurance arrangements is not superseded.

Accounting Considerations

An institution may purchase multiple permanent insurance policies from the same insurance carrier, with each policy having its own surrender charges. In some cases, the insurance carrier will issue a rider or other contractual provision stating that it will waive the surrender charges if all of the policies are surrendered at the same time. Because it is not known at any balance-sheet date whether one or more of the policies will be surrendered before the deaths of the insureds, the possibility that the institution will surrender all of these policies simultaneously and avoid the surrender charges is a gain contingency. This guidance should be applied to all insurance policies held by an institution regardless of when they were acquired. Therefore, an institution that has purchased BOLI is required to report the CSV on the bank's balance sheet net of the surrender charges (even if the policies have been in force for some time and the institution's auditors have not previously required reporting the CSV net of the surrender charges).

Based on the agencies' review of FASB Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4), including its appendix, the agencies believe that TB 85-4 is intended to be applied on a policy-by-policy basis. It, therefore, does not permit the aggregation of multiple separate policies for balance-sheet-measurement purposes. Accordingly, the agencies do not intend to defer to institutions or their auditors on this issue. As of the balance-sheet date, an institution should determine the amount that could be realized under each separate insurance policy on a stand-alone basis without regard to the existence of other insurance policies or riders covering multiple policies. If a single insurance policy covers more than one individual, the realizable amount of the entire policy should be determined. A single insurance policy covering multiple individuals should not be subdivided into hypothetical separate policies for each covered individual, even if the carrier reports CSVs for each covered individual.

If a change in an institution's accounting for its holdings of life insurance is necessary for regulatory reporting purposes, the institution should follow Accounting Principles Board Opinion No. 20, "Accounting Changes"(APB 20).[17] APB 20 defines various types of accounting changes and addresses the reporting of corrections of errors in previously issued financial statements. APB 20 states that "[e]rrors in financial statements result from mathematical mistakes, mistakes in the application of accounting principles, or oversight or misuse of facts that existed at the time the financial statements were prepared."

For regulatory reporting purposes, an institution must determine whether the reason for a change in its accounting for its holdings of life insurance meets the APB 20 definition of an accounting error. If the reason for the change meets this definition and the amount is material, the error should be reported as a prior-period adjustment in the institution's regulatory reports. Otherwise, the effect of the correction of the error should be reported in current earnings. If the effect of the correction of the error is material, the institution should also consult with its primary federal regulatory agency to deter-

17. Effective December 15, 2005, APB 20 will be replaced by FASB Statement No. 154, "Accounting Changes and Error Corrections—A replacement of APB Opinion No. 20 and FASB Statement No. 3."

mine whether any previously filed regulatory reports should be amended. For the Call Report, the institution should report the amount of the adjustment in Schedule RI-A, item 2, “Restatements due to corrections of material accounting errors and changes in accounting principles,” with an explanation in Schedule RI-E, item 4. The effect of the correction of the error on income and expenses since the beginning of the period in which the correction of prior-period earnings is reported should be reflected in each affected income and expense account on a year-to-date basis in the Call Report Income Statement (Schedule RI), not as a direct adjustment to retained earnings.

Rate of Return to the Bank in Split-Dollar Insurance Arrangements

The agencies would consider the institution’s economic interest in a split-dollar life insurance arrangement policy, at a minimum, to be a return of the premiums paid plus a reasonable rate of return. The agencies would generally consider a reasonable rate of return to be one that provides the bank a return that is commensurate with alternative investments having similar risk characteristics (including credit quality and term) at the time in which the bank enters into the split-dollar arrangement. The rate of return is to be calculated net of any payments made (or to be made) from insurance proceeds to the employee’s beneficiaries.

The agencies look at the economic value of compensation arrangements when determining the reasonableness of split-dollar compensation, but the agencies do not rely solely on income tax rules for determining this economic value. Other factors that the agencies might consider include, but are not limited to, the benefit of a split-dollar arrangement to the employee as a percentage of salary and the expected length of time until the institution recovers its invested funds.

1. To determine the level and direction of risk that purchases and holdings of life insurance pose to the state member bank, and to recommend corrective action, as appropriate.
2. To perform—
   a. a risk assessment that summarizes the level of inherent risk by risk category, and
   b. an assessment of the adequacy of the board of directors' and management's oversight of the activity, including an assessment of the bank's internal control framework.
3. To ensure that the risk assessment considers a state member bank's purchase and risk management of its—
   a. broad bank-owned life insurance (BOLI) programs, in which life insurance is purchased on a group of employees to offset employee benefit programs and the bank is the beneficiary;
   b. split-dollar insurance arrangements for individual (usually senior-level) bank employees; and
   c. holdings of key-person insurance.
4. Recognizing that management may not be as familiar with insurance products as it is with more-traditional bank products, to adequately identify and assess the risks of BOLI, as well as the risk exposures that may arise from purchases and holdings of life insurance.[1]
5. To apply a forward-looking approach to the review of a bank's purchase and risk management of life insurance, recognizing that the bank may be exposed to increasing operational risks as a result of its large purchases or holdings of this product. These risks may arise from—
   a. separate-account assets that contain holdings of complex equity-linked notes and derivative products;
   b. the growing use of guaranteed minimum death benefits and other complex guarantee structures, which may increase the operational risk to banks purchasing significant amounts of life insurance; and
   c. the potential losses that could result from—
      - inadequate recordkeeping, which may be related to tracking the potentially large variety of contracts and agreements and the potentially large number of insured current and former employees covered by the contracts, and
      - a failure to ensure that contract agreements between the insurance company, the vendor(s), and the employees are properly executed and honored.

1. As noted in more depth in section 4042.1, the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance, these risks include operational, liquidity, credit, legal, and reputational risk. Operational risk arises in part from the vast array of new life insurance products and structures being offered and from the complexity of tax considerations related to the products, under various state insurable-interest and federal tax laws.

PRELIMINARY RISK ASSESSMENT

1. Consider the following, among other relevant criteria as appropriate, when determining whether to include the review of bank-owned life insurance (BOLI) in the examination scope:
   a. the volume, growth, and complexity of BOLI purchases and holdings
      - Consider the amount of the bank's BOLI holdings, measured by the total of their cash surrender values (CSVs) as a percentage of capital, and determine whether the resulting percentage is an asset concentration of capital. (For state member banks, the Federal Reserve has defined the capital base for determining this concentration threshold to be a percentage of tier 1 capital plus the allowance for loan and lease losses.) Determine whether the BOLI holdings have grown or declined significantly in recent years, when compared with the BOLI holdings of peer banks (consult the Federal Reserve System's intranet for applicable surveillance and monitoring data).
      - Obtain a breakout of the CSV of BOLI assets, as reported on the bank's balance sheet, including the amounts attributable to split-dollar insurance arrangements, general BOLI plans covering a group of employees to recover the cost of employee compensation and benefit programs, and the amount, if any, attributable to key-person insurance.
      - Obtain a listing of the amount of the bank's reimbursable premium payments under split-dollar life insurance arrangements and the amount receivable for these policies, which is to be booked as "other assets" on the bank's balance sheet.
      - Determine whether a portion of the CSV is in separate-account holdings of a life insurance company. If the bank has separate-account holdings, determine (1) the composition of the underlying separate-account assets and (2) if these assets constitute higher-risk investments, including equity-linked notes, mortgage-backed securities with significant interest-rate risk, or other investments entailing significant market risk.
      - Determine whether any of the life insurance policies are held in out-of-state trusts. If so, ascertain—
        — whether management and the board of directors can demonstrate that they have performed an independent legal analysis to ensure that the legal structure employed does not jeopardize the bank's insurable interest in the insurance policies or its access to the policy proceeds, as applicable; and
        — whether the trust arrangement inappropriately disadvantages the bank (for example, by permitting inappropriate investments or permitting the insured or the beneficiary to borrow against the policy holding in such a way that could jeopardize the bank's ability to recover amounts owed to it under the trust agreement).
   b. BOLI concentrations
      - Determine if there is a CSV concentration of life insurance to one carrier in excess of 25 percent that includes both separate-account and general-account BOLI holdings.
      - Determine if there are any market-risk concentrations within the underlying separate-account assets, including, for example, interest-sensitive fixed-income holdings.
      - Determine if there are any equity-linked notes or direct equity holdings in the separate accounts.
      - Determine if the bank holds any large-exposure life insurance policies on particular individuals. If so, determine if the policies are split-dollar arrangements and, if so—
        — whether the board or a board committee has evaluated the rea-

sonableness of the compensation as part of the employee's overall compensation package, and

— whether the board or a board committee has determined that the overall compensation is appropriate.

c. the appropriateness and recency of materials presented to the bank's board of directors concerning the bank's purchase and risk management of life insurance relative to its insurance purchases and holdings
d. the appropriateness and recency of audits and compliance reviews of the bank's purchases and risk management of life insurance
e. the overall financial condition of the bank, its supervisory rating, and any concerns or potential concerns about its liquidity

2. Depending upon the outcome of the preliminary risk assessment and other relevant factors, consider performing the following examination procedures.

OPERATIONAL-RISK ASSESSMENT

Senior Management and Board Oversight

1. Evaluate whether board and senior management oversight is effective and ensures that the bank's purchases and holdings of BOLI are consistent with safe and sound banking practices.
2. Determine whether the board of directors understands the complex risk characteristics of the bank's insurance holdings and the role of BOLI in the bank's overall business strategy.

Accounting Considerations

3. Determine if the bank's financial and regulatory reporting of its life insurance activities follows applicable generally accepted accounting principles (GAAP), including the following guidance:
   a. *Financial Accounting Standards Board (FASB) Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance" (TB 85-4).* Only the amount that can be realized under an insurance contract as of the balance-sheet date (that is, the CSV reported to the bank by the insurance carrier, less any applicable surrender charges not reflected by the insurance carrier in the reported CSV) is reported as an asset. Since there is no right of offset, a BOLI investment is reported as an asset separately from any deferred compensation liability, provided that it was not purchased in connection with a tax-qualified plan.
   b. *Call Report instructions.* The bank is required to report the carrying value of its BOLI holdings (CSV net of applicable surrender charges) as a component of "other assets" and to report the earnings on these holdings as "other noninterest income."
4. Verify that the bank's deferred compensation agreements were accounted for using the guidance in the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance.
5. Verify that any accounts receivable that represent the bank's reimbursable life insurance premiums paid are recorded as unimpaired account receivables (for example, life insurance policies that are not impaired as a result of declining CSVs backing the obligations or employees borrowing against CSVs). (Impaired amounts should be expensed.)

Policies and Procedures

6. Assess the adequacy of the bank's policies and procedures governing its BOLI purchases and holdings, including its guidelines to limit the aggregate CSV of policies from one insurance company as well as limit the aggregate CSV of policies from all insurance companies.
7. Verify if the bank's board of directors or the board's designated committee approved BOLI purchases in excess of 25 percent of capital or in excess of any lower internal limit. (For state member banks, the Federal Reserve has defined the capital base for determining this concentration threshold to be a percentage of tier 1 capital plus the

allowance for loan and lease losses.)

8. Determine the reasonableness of the bank's internal limits and whether management and the board of directors have considered, before purchasing BOLI, the bank's legal lending limit, its applicable state and federal capital concentration threshold, and any other applicable state restrictions on BOLI.
9. For banks that may have other credit exposures to insurance companies, determine if the bank has considered the credit exposures arising from its BOLI purchases when assessing its overall credit exposure to a carrier and to the insurance industry.
10. Determine whether the bank's management has justified and analyzed the risks associated with a significant increase in the bank's BOLI holdings.
11. Determine if the bank has advised its board of directors of the existence of the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance and of the risks associated with BOLI.

Pre-Purchase Analysis

12. Ascertain whether the bank maintains adequate records of its pre-purchase analysis of BOLI.
13. Evaluate whether the bank's board of directors, or a designated board committee, and senior management understand the risks, rewards, and unique characteristics of BOLI.

Need for Insurance, Economic Benefits, and Appropriate Insurance Type

14. Determine whether the bank identified the specific risk of loss to which it is exposed or the specific costs to be recovered by the purchase of life insurance.
15. Determine whether the bank analyzed the costs and benefits of planned BOLI purchases.

Amount of Insurance Appropriate for the Institution's Objectives

16. Find out if the bank estimated the size of its employee benefit obligation or the risk of loss to be covered in order to ensure that the amount of BOLI purchased was not excessive in relation to this estimate and the associated product risks.
17. Determine whether management can support, with objective evidence, the reasonableness of all of the assumptions used in determining the appropriate amount of insurance coverage needed by the bank, including the rationale for its discount rates and cost projections.

Vendor Qualifications

18. Evaluate whether the bank's management assessed its own knowledge of insurance risks, the vendor's qualifications, the amount of resources the bank is willing to spend to administer and service the BOLI, and the vendor's ability to honor the long-term financial commitments associated with BOLI.

Characteristics of Available Insurance Products

19. Evaluate whether the bank's management has reviewed and understands the characteristics of the various life insurance products available and of the products it has acquired.
20. Ascertain if and how the bank's management reviewed and selected the life insurance product characteristics that best matched its objectives, needs, and risk tolerance. Ascertain whether management evaluated and documented, before the bank acquired BOLI, the risks of the variety and complexity of life insurance products considered, how the selected insurance product works, the variables that affect the product's performance, and the applicable tax and accounting treatments.
21. Determine whether the bank's management reviewed and documented its consideration of the types and design features of BOLI. Determine whether management reviewed and documented the negotiable features associated with a separate-account insurance product (for example, its investment options, terms, and conditions; the cost of stable value protection (SVP); deferred acquisition costs (DAC); and mortality options) and with any SVP provider that

may have been separately contracted by the insurance carrier.

22. Verify that the bank's management conducted a thorough review of life insurance policies before acquiring the policies. Ascertain if management determined how the accounting rules would apply to those policies and if it understood any ambiguous contract provisions, such as costs, charges, or reserves, that may affect the amount of a policy's CSV.

Tax and Insurable-Interest Implications

23. For the bank's pre-acquisition review of BOLI and its subsequent BOLI purchases, verify that the bank's management considered and documented its analysis of the financial impact of surrendering a policy (for example, any tax implications).
24. Verify that the bank's management obtained appropriate legal reviews. An appropriate legal review ensures that—
    a. the bank complies with applicable tax and state insurable-interest requirements, and
    b. the bank's insured amounts are *not* excessive (therefore, the bank is not involved in impermissible speculation or unsafe and unsound banking practices).

Carrier Selection

25. Find out if the bank (1) reviewed the BOLI product's design and pricing and the administrative services of the proposed carrier and (2) compared these services with those of other insurance carriers.
26. Ascertain whether the bank's management reviewed the selected carrier's ongoing long-term ability to commit to the BOLI product, as well as its credit ratings, general reputation, experience in the marketplace, and past performance.
27. Determine if the bank performed a credit analysis on the selected BOLI carriers and if the analysis was consistent with safe and sound banking practices for commercial lending.

Split-Dollar or Other Insurance Arrangements That Result in Additional Insured Employee Compensation

28. When a bank acquires insurance that permits a bank officer or employee to designate a beneficiary or provides the officer or employee with additional compensation, determine if the bank identified and quantified its total compensation objective. Determine if the bank ensured (1) that the acquired split-dollar life or other insurance arrangement was consistent with that objective, including when insurance compensation is combined with all other compensation being provided, and (2) that the total compensation was not excessive.
29. Verify that the bank and the insured have entered into a written agreement that specifically states the bank's rights, the insured individual's rights, and the rights of any other parties (trusts or beneficiaries) to the policy's CSV and death benefits.
30. Verify that the bank's shareholders and their family members (who are not bank officers, directors, or employees and who do not provide goods and services to the bank) do not receive compensation in the form of split-dollar life or other insurance coverage benefits.
31. Determine whether the bank's management has assessed the bank's ability to borrow against the CSV of its split-dollar life insurance policies, as well as the ability of other parties (whether an insured officer, employee, or noninstitution owner) to borrow against the policy CSV, without impairing the bank's financial interest in the policy proceeds. Determine also—
    a. if the bank can liquidate the policy in order to meet liquidity needs; or
    b. if the bank effects an early policy surrender (such as might occur if an employee terminates his or her employment), if the surrender would preclude the bank from recovering its premium payments and a market rate of return on the premiums invested.
32. Determine if and how management verified that the bank would be able to recover its premium payments plus a market rate of return on the premiums invested, after the payment of policy proceeds to the employee's beneficiary under the split-dollar arrangement.

Other Elements of Pre-Purchase Analysis

33. Ascertain whether the bank's management thoroughly evaluated all significant risks. Determine whether management has established procedures to identify, measure, monitor, and control those risks.
34. Find out if the bank, before acquiring BOLI, thoroughly analyzed its associated risks and benefits. As appropriate, determine whether the bank compared the risks of BOLI with those of alternative methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation.

Post-Purchase Analysis

35. Find out if management reviewed at least annually the bank's life insurance purchases and holdings with the bank's board of directors.[1] Ascertain if the review included, at a minimum—
    a. a comprehensive assessment of the specific risks associated with the bank's permanent insurance acquisitions;
    b. an identification of the bank's employees who are or will be insured (for example, vice presidents and above, employees of a certain grade level, etc.);
    c. an assessment of death benefit amounts relative to employee salaries;
    d. a calculation of the percentage of insured persons still employed by the bank;
    e. an evaluation of the material changes to BOLI risk-management policies;
    f. an assessment of the effects of policy exchanges;
    g. an analysis of mortality performance and the impact on income;
    h. an evaluation of material findings from internal and external audits and independent risk-management reviews;
    i. an identification of the reason for, and the tax implications of, any policy surrenders; and
    j. a peer analysis of BOLI holdings.

1. More-frequent reviews should be conducted if significant changes to the BOLI program are anticipated, such as additional purchases, a decline in the financial condition of the insurance carrier(s), anticipated policy surrenders, or changes in tax laws or interpretations that could have an impact on the performance of BOLI.

LIQUIDITY-RISK ASSESSMENT

1. Find out if management, before the bank's purchase of permanent insurance, recognized the illiquid nature of the bank's acquisition of its permanent insurance products. Determine whether management ensured that the bank had the long-term financial flexibility to continue holding the insurance assets for their full term of expected use.
2. Determine if management, before the bank's purchase of permanent insurance, adequately considered the contractual arrangements and product types that limit product liquidity in order to best optimize the value of the bank's insurance assets and their possible future use as liquidity and funding sources. Contract provisions that should be considered include—
    a. 1035 exchange fees and "crawl-out restrictions,"
    b. provisions that would result in the product's categorization for federal tax purposes as a modified endowment contract (MEC) or a non-MEC contract, and
    c. SVP contract provisions that may limit the bank's ability to surrender a policy early or that would increase the cost of an early surrender.

REPUTATION-RISK ASSESSMENT

1. Ascertain whether the bank has taken steps, including obtaining written consent from its insured officers and employees, to reduce its reputation risk that may result from BOLI purchases.
2. Determine if the bank maintains appropriate documentation evidencing that it obtained a formal written consent from its insured officers and employees.
3. Find out what segment of the employee base the bank has insured (i.e., officers or non-officers) and if the bank has taken out very high death benefit policies on employees, including lower-level employees.

CREDIT-RISK ASSESSMENT

1. Determine if the bank's management con-

ducted an independent financial analysis of the insurance carrier before the bank's purchase of a life insurance policy.
   a. Ascertain if management continues to monitor the life insurance company's condition on an ongoing basis.
   b. Verify that the bank's credit-risk management function participated in the review and approval of insurance carriers.
2. Determine whether the bank considered its legal lending limit, its credit concentration guidelines (the aggregate exposures to individual insurance carriers and the life insurance industry, including other bank credit relationships, such as credit exposures involving loans and derivatives), and any state restrictions on BOLI holdings.
3. Determine whether the bank's credit analysis of its BOLI holdings evaluated whether the policies to be acquired were either separate-account or general-account policies.
   a. Find out whether the separate-account policies included an SVP contract to protect the bank (as a policyholder) from declines in the fair value of separate-account assets.
   b. Ascertain if the bank evaluated the insurance carrier's separately contracted SVP provider's repayment capacity.

MARKET-RISK ASSESSMENT

1. Determine whether management fully understood (before the bank purchased its separate-account products)—
   a. how the life insurance products expose the bank to interest-rate risk;
   b. the instruments governing the investment policy, as well as how the separate account is managed;
   c. the inherent risk of a separate account; and
   d. whether the bank's risk from the purchase of separate-account products was appropriate.
2. For general-account products, ascertain if management understands the interest-crediting option the bank chose when purchasing the insurance policy.
3. Find out if the bank has established and if it maintains appropriate monitoring and reporting systems for interest-rate fluctuations and their effect on separate-account assets.
4. Find out if the bank has acquired an SVP contract for its separate-account policy in order to reduce income-statement volatility. (SVP contracts protect against declines in value attributable to changes in interest rates; they do not cover default risk.)
5. If the bank has not purchased an SVP contract, determine if management has established and maintained monitoring and reporting systems that will recognize and respond to price fluctuations in the fair value of separate-account assets.
6. If the bank has purchased an equity-linked variable life insurance policy, determine whether it is characterized as an effective economic hedge against the bank's equity-linked obligations under its employee benefit plans. (An effective hedge exists when changes in the economic value of the liability or other risk exposure being hedged are matched by counterbalancing changes in the value of the hedging instruments. The economic hedging criteria for equity-linked insurance products lessen the effect of price risk because changes in the amount of the equity-linked liability are required to offset changes in the value of the separate-account assets.)
7. If the bank is purchasing or has purchased a separate-account insurance product involving equity securities, determine if the bank's management has performed further analysis that—
   a. compares the equity-linked liability being hedged and the equity securities in the separate account,
   b. determines a target range for the hedge-effectiveness ratio and establishes a method for measuring ongoing hedge effectiveness, and
   c. establishes a process for analyzing and reporting to management and the board of directors the effect of the hedge on the bank's earnings and capital ratios (both with and without the hedging transaction).

COMPLIANCE/LEGAL-RISK ASSESSMENT

1. Determine whether the bank's compliance

and audit functions have evaluated its compliance with applicable state insurable-interest and federal tax laws in order to protect the bank's earnings and capital from the loss of tax benefits or from the imposition of fines or penalties by regulatory authorities for violations of, or noncompliance with, laws, rulings, regulations, prescribed practices, and ethical standards.

2. When the bank owns separate-account BOLI, determine whether the bank has implemented and maintains internal control policies and procedures that adequately ensure that it does not take any action that might be interpreted as exercising "control" over separate-account assets.
3. Determine whether the bank split commissions between a vendor and the bank's own subsidiary or affiliate insurance agency when purchasing life insurance. If so, determine whether the bank's compliance function has assessed the bank's compliance with state and federal securities and insurance laws regarding fee and commission arrangements.
4. Ascertain whether the bank seeks and documents the advice of legal counsel when determining legal and regulatory issues, requirements, and concerns related to its potential purchase or ownership of BOLI.
5. For a general-account insurance product, determine if the bank has assigned a standard risk weight of 100 percent to the general-account asset.
6. For a BOLI separate-account product (when the bank uses the look-through approach to assign risk weights according to the risk-based capital rules)—
   a. review the bank's documentation, and determine if the bank adequately verified that the separate-account BOLI assets are protected from the insurance company's general creditors in the event of the insurance company's insolvency;
   b. determine if the standard risk weight of 100 percent was assigned to the bank's BOLI assets when the bank's documentation is inadequate or does not exist;
   c. verify that a 100 percent risk weight has been assigned to (1) the portion of the bank's insurance asset that represents general-account claims on the insurer (such as DAC and mortality reserves that are realizable on the balance-sheet date) and (2) any portion of the carrying value attributable to an SVP contract (or if the SVP provider is not an insurance company, verify that the correct risk weight has been assigned for that obligor); and
   d. if the bank used a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy—
      - verify that the risk weight is applied to the separate account based on the most risky portfolio that could be held by the separate account (as stated in the investment agreement), except for any portions of the carrying value that are general-account claims attributable to either DAC or an SVP (which are generally risk-weighted at 100 percent);
      - verify that in no case may the assigned risk weight for the bank's entire separate-account holding be less than 20 percent; and
      - when the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, determine if the bank assigned the highest risk weight for the maximum amount permitted in that asset class, and then applied the next-highest risk weights to the other asset classes until the aggregate of the permitted amounts equals 100 percent.

Examiners should use only those internal control questions that are appropriate, given the size, complexity, and growth of a bank's bank-owned life insurance (BOLI) holdings.

PRELIMINARY RISK ASSESSMENT

1. Have the steps for conducting a preliminary risk assessment been followed, as they are set forth in section 4042.3? Have other relevant factors been considered to determine if further examination review may be warranted, in accordance with risk-focused supervision guidelines?
2. What particular factors have been identified to warrant a review of the bank's purchases and risk management of life insurance?

OPERATIONAL-RISK ASSESSMENT

Senior Management and Board of Directors Oversight

1. Has senior management and the board of directors initiated and maintained effective oversight of the bank's BOLI by—
   a. performing a thorough pre-purchase analysis of its risks and rewards and a post-purchase risk assessment?
   b. determining the permissibility of the bank's BOLI purchases and holdings under both the applicable state and federal requirements (whichever requirements are more restrictive)?
   c. determining the types and kinds of risks that are associated with BOLI?
   d. ascertaining and reviewing the safety-and-soundness considerations associated with the bank's BOLI?
   e. understanding the complex risk characteristics of the bank's insurance holdings and what role BOLI is to play in the bank's overall business?
2. Does the bank have a comprehensive risk-management process for purchasing and holding BOLI?

Accounting Considerations

3. When accounting for its holdings of life insurance, did the bank follow the guidance in FASB's Technical Bulletin No. 85-4, "Accounting for Purchases of Life Insurance"? Are the bank's insurance policies reported on its balance sheet on the basis of each policy's cash surrender value (CSV), less any applicable surrender charges that are not reflected in the reported CSV?
4. On the bank's Call Report, did the bank's management —
   a. report the carrying value of its BOLI holdings as an "other asset"?
   b. report the earnings on the bank's holdings as "other noninterest income"?
   c. report the CSV separately, as required if the CSV amount exceeded the reporting threshold?
   d. expense only the noninvestment portion of the premium, in the case of bank-owned policies?
   e. expense the premium for employee-owned insurance purchased by the bank and record a receivable in "other assets" for any portion of the premium to be reimbursed to the bank under a contractual agreement?
5. Were the bank's deferred compensation agreements accounted for using the guidance in the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance?

Policies and Procedures

6. Does the bank have comprehensive policies and procedures, including guidelines, that limit the aggregate CSV of policies from any one insurance company, as well as the aggregate CSV of policies from all insurance companies?
   a. Does the board of directors or a designated board committee require senior management to provide adequate and appropriate justification for establishing or revising internal CSV limits on the amount of BOLI the bank holds? Does

this justification take into account the bank's legal lending limits, its capital and credit concentration threshold, and any applicable laws and regulations?

b. Is written justification required when the amount of the bank's BOLI holdings approaches or exceeds 25 percent of the bank's capital (tier 1 capital plus the allowance for loan and lease losses)? Does the board of directors or a board committee approve this justification?

Pre-Purchase Analysis

7. Did the bank's management perform a written pre-purchase analysis of its BOLI products?
8. Did management identify the bank's need for BOLI, the appropriate type of insurance to be acquired, and the economic benefits to be derived from the purchase of BOLI? Did this analysis accomplish the following:
   a. identify the specific risk of loss to be covered by the insurance, or the costs the insurance is supposed to cover?
   b. determine what type BOLI (for example, general- or separate-account) and what BOLI features are needed, before acquiring the product?
   c. evaluate the permissibility and market risk of any underlying separate-account asset holdings, if separate-account BOLI is held?
   d. analyze projected policy values (CSV and death benefits) using various interest-crediting rates and mortality cost assumptions?
   e. estimate the size of the employee benefit obligation or the risk of loss to be covered? Did management ensure that the amount of BOLI coverage was appropriate for the bank's objectives and that BOLI was not excessive in relation to this estimate and the associated product risks?
   f. review the range of assumptions? Was management able to justify the assumptions with objective evidence, and deem them reasonable in view of previous and expected market conditions?
   g. assess whether the present value of the BOLI's expected future cash flows (net of the costs of the insurance) is less than the estimated present value of the expected after-tax employee benefit costs, when the bank uses BOLI to recover the costs of providing employee benefits?
9. Did the bank's management —
   a. review and assess its own knowledge of insurance risks, the vendor's qualifications, and the amount of the bank's resources that will be needed to administer and service the BOLI?
   b. demonstrate its familiarity with the technical details of the bank's insurance assets, and is management able to explain the reasons for and the risks associated with the product design features that have been selected?
   c. make appropriate inquiries to determine whether the vendor has the financial ability to honor its long-term commitments over an extended period of time?
   d. assure itself of the vendor's commitment to investing in the operational infrastructure that is necessary to support the BOLI?
   e. undertake its own independent review and not rely solely on prepackaged, vendor-supplied compliance information (such reliance is a potential cause for supervisory action)?
   f. properly evaluate the characteristics of the available insurance products against the bank's objectives, needs, and risk tolerance?
   g. determine if the bank's need for insurance on key persons or on a borrower's loan resulted in a matching of the maturity of the term or declining term insurance to the key person's expected tenure or the maturity of the borrower's loan?
   h. conduct a review of the insurance carrier that included—
      - a credit analysis of the potential insurance carrier (the analysis should have been performed in a manner consistent with safe and sound banking practices for commercial lending)?
      - a review of the bank's needs and a comparison of those needs with the proposed carrier's product design, pricing, and administrative services?
      - a review of the insurance carrier's commitment to the BOLI product, as well as the carrier's general reputation, experience in the marketplace, and past performance?

   i. determine whether the total amount of compensation and insurance to be provided to an employee is excessive, if the purchased BOLI will result in the payment of additional compensation?
   j. analyze the associated significant credit risks and the bank's ability to monitor and respond to those risks?
   k. as appropriate, analyze the risks and benefits of BOLI, compared with other available methods for recovering costs associated with the loss of key persons, providing pre- and post-retirement employee benefits, or providing additional employee compensation?
   l. sufficiently document its comprehensive pre-purchase analysis (including its analysis of both the types and product designs of purchased BOLI and the bank's overall level of BOLI holdings)?

Post-Purchase Analysis

10. Do management and the board of directors annually review the performance of the bank's insurance assets? Does the annual review include—
   a. a comprehensive assessment of the specific risks associated with permanent insurance acquisitions?
   b. an identification of employees who are or will be insured (e.g., vice presidents and above, employees of a certain grade level)?
   c. an assessment of death benefit amounts relative to employee salaries?
   d. a calculation of the percentage of insured persons still employed by the institution?
   e. an evaluation of the material changes to BOLI risk-management policies?
   f. an assessment of the effects of policy exchanges?
   g. an analysis of mortality performance and the impact on income?
   h. an evaluation of material findings from internal and external audits and independent risk-management reviews?
   i. an identification of the reason for and the tax implications of any policy surrenders?
   j. a peer analysis of BOLI holdings?

Tax and Insurable-Interest Implications

11. Has the bank's management explicitly considered the financial impact (for example, the tax provisions and penalties) of surrendering a BOLI policy?
12. Does the bank's management have or has it obtained appropriate legal review to ensure that it will be in compliance with applicable tax and state insurable-interest requirements? Is management aware of the relevant tax features of the insurance assets, including whether the bank's purchase would—
   a. make the bank subject to the alternative minimum tax?
   b. jeopardize the tax-advantaged status of the bank's insurance holdings?
   c. qualify (under applicable state law) an insurable ownership interest in the BOLI policy covering the bank's officers or its employees (including any applicable state law pertaining to the insured's consent and the amounts of allowable insurance coverage for an employee)?
13. Did the bank establish an out-of-state trust to hold its BOLI assets, and, if so, has the bank adequately assessed its insurable interest, given the arrangement?

LIQUIDITY-RISK ASSESSMENT

1. Has the bank's management fully recognized and considered the illiquid nature of the BOLI to be acquired? (An institution's BOLI holdings should be considered when assessing liquidity and assigning the component rating for liquidity.)
2. Did management determine if the bank has the long-term financial flexibility to hold the insurance asset for the full term of its expected use?

REPUTATION-RISK ASSESSMENT

1. Has the bank's management implemented procedures to ensure that the bank maintains appropriate documentation that evidences employees' informed consent for the bank's purchase of insurance on their lives? Do these procedures ensure that the bank

obtains employees' explicit consent before purchasing the insurance?

2. Has the bank obtained insurance products that insure large segments of its employee base (including the bank's non-officers)? Do these policies provide very high death benefits on employees, possibly causing the bank to be exposed to increased reputation risk if explicit consent was not obtained from the employees?

CREDIT-RISK ASSESSMENT

1. Did the bank's management conduct an independent financial analysis of the insurance carrier before purchasing the life insurance policy?
   a. Does management continue to monitor the life insurance company's financial condition on an ongoing basis?
   b. Did the bank's credit-risk management function participate in the review and approval of insurance carriers?
2. When establishing exposure limits for aggregate BOLI holdings and exposures to individual carriers, did the bank's management consider—
   a. the bank's legal lending limit?
   b. the applicable state and federal credit concentration exposure guidelines?
   c. the aggregate CSV exposures as a percentage of the bank's capital?
3. Has the bank's credit-risk management process taken into account credit exposures arising from both BOLI holdings and other credit exposures (loans, derivatives, and other insurance products) when measuring exposures to individual carriers?
4. Did the bank's credit analysis of its BOLI holdings consider whether the policies to be acquired were separate-account or general-account policies?
   a. For the separate-account policies, did the credit review include a risk analysis of the underlying separate-account assets?
   b. For separate-account policies that include a stable value protection (SVP) contract, has the repayment capacity of the insurance carrier's separately contracted SVP providers been evaluated?

MARKET-RISK ASSESSMENT

1. Did management adequately assess the interest-rate risk exposure of BOLI before purchasing the products for separate-account and general-account assets?
2. Has the bank's management reviewed, and does it understand the instruments governing the separate-account investment policy and its management?
   a. Does the bank's management understand the risk inherent within the separate account?
   b. Has the bank's management determined if the risk is appropriate?
3. Have monitoring and reporting systems been established that will enable the bank's management to monitor, measure, and appropriately manage interest-rate risk exposure from BOLI holdings when assessing the bank's overall sensitivity to interest-rate risk?

COMPLIANCE/LEGAL-RISK ASSESSMENT

1. Has the bank's audit and/or compliance function reviewed the bank's legal and regulatory requirements as they pertain to life insurance holdings? Did the review consider—
   a. state insurable-interest laws?
   b. the Employee Retirement Income Security Act of 1974 (ERISA)?
   c. the Federal Reserve Board's Regulation W (12 CFR 223)?
   d. applicable federal prohibitions on insider loans, including the Federal Reserve Board's Regulation O, that may apply to split-dollar life insurance arrangements?
   e. the interagency guidelines for establishing standards for safety and soundness?[1]
   f. other state and federal regulations applicable to BOLI?
2. To ensure that the life insurance qualifies for its tax-advantaged status, has the bank's management implemented and maintained internal policies and procedures to ensure that "control" will not be exercised over any of the separate-account assets, espe-

1. For state member banks, see 12 CFR 208, appendix D-1.

cially those involving privately placed policies?

3. Does the bank's board of directors, its designated board committee, and its management seek the assistance of legal counsel when determining the legal and regulatory issues related to the acquisition and holding of life insurance policies?
4. Has management thoroughly reviewed, and does it understand, the instruments governing the investment policy and the management of a separate account, before purchasing a separate-account policy?
5. If the bank has not purchased SVP for a separate-account BOLI policy, has management established the appropriate monitoring and reporting systems that will enable it to recognize and respond to price fluctuations in the fair value of the separate-account assets?
6. When the bank considers or purchases a separate-account BOLI product involving equity securities, does it analyze the equity securities? Does this analysis—
   a. compare the specific equity-linked liability being hedged against the securities held in a separate account?
   b. establish a target ratio for hedge effectiveness, as well as a method for measuring hedge effectiveness on an ongoing basis?
   c. establish a process for analyzing and reporting to the board of directors, its designated committee, and senior management the effect of the hedge on the bank's earnings and capital ratios (this analysis should include a consideration of the results both with and without the hedging transaction)?
7. When reporting its risk-based capital, has the bank ensured that it accurately calculates and reports its risk-weighted assets for BOLI holdings according to the risk-based capital guidelines and the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance (see section 4042.1 and SR-04-19 and its attachment)?
   a. For a general-account insurance product, has the bank applied a standard risk weight of 100 percent to the general-account asset?
   b. When the bank has applied a look-through approach for separate-account holdings—
      - has management determined if BOLI assets would be protected from the insurance company's general creditors in the event of its insolvency? Has the bank documented its assessment that BOLI assets are protected?
      - has the portion of the carrying value of the separate-account policy (that reflects the amounts attributable to the insurer's DAC and mortality reserves, and any other portion that is attributable to the carrying value of an SVP contract) been risk-weighted using the 100 percent risk weight applicable to the insurer's general-account obligations? Or, if the SVP provider is not an insurance company, has the portion of the carrying value been risk-weighted as appropriate for that obligor?
8. When the bank has used a pro rata approach to risk-weighting the carrying value of a qualifying separate-account policy, did it use the appropriate procedures, as outlined in the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance (see section 4042.1 and SR-04-19 and its attachment)?
   a. Has the bank ensured that its assigned aggregate risk weight for all separate-account BOLI holdings will be 20 percent or more?
   b. When the sum of the permitted investments across market sectors in the investment agreement is greater than 100 percent, was the highest risk weight applied for the maximum amount permitted in that asset class, and was the next-highest risk weight then applied until the cumulative permitted amounts equal 100 percent?

Banking organizations have long been engaged in the sale of insurance products and annuities, although these activities historically have been subject to several restrictions. For example, until recently, national banks could sell most types of insurance, but only through an agency located in a small town. Bank holding companies also were permitted to engage in only limited insurance agency activities under the Bank Holding Company Act. State-chartered banks, on the other hand, generally have been permitted to engage in insurance sales activities as agents to the extent permitted by state law.

The Gramm-Leach-Bliley Act of 1999 (the GLB Act), however, authorized national banks and state-chartered member banks to sell all types of insurance products through a financial subsidiary. *The GLB Act generally did not change the powers of banks to sell insurance directly.* As a result of the GLB Act and marketplace developments, many banking organizations are increasing the range and volume of their insurance and annuities sales activities. To the extent permitted by applicable law, banking organizations may conduct insurance and annuity sales activities through a variety of structures and delivery channels, including ownership of an insurance underwriter or an insurance agency or broker, the employment by a bank of licensed agents, a joint marketing arrangement with a producer,[1] independent agents located at a bank's office, direct mail, telemarketing, and Internet marketing.

A banking organization may also conduct insurance or annuity sales activities through a managing general agent (MGA). An MGA is a wholesaler of insurance products and services to insurance agents. The MGA has a contractual agreement with an insurance carrier to assume functions for the carrier, which may include marketing, accounting, data processing, policy recordkeeping, and monitoring or processing claims. The MGA may rely on various local agents or agencies to sell the carrier's products. Most states require an MGA to be licensed.

OVERVIEW AND SCOPE

The following guidance pertains to state member banks that are either directly or indirectly engaged in the sale of insurance or annuity products. Examiner guidance on performing appropriate risk assessments of a state member bank's insurance and annuity sales activities is included.[2] Additionally, guidance is provided for examining a state member bank's compliance with the consumer protection rules relating to insurance and annuities sales activities that are contained in the Board's December 2000 revisions to Regulation H (subpart H) (12 CFR 208.81–86), ''Consumer Protection in Sales of Insurance'' (CPSI). Subpart H, which became effective on October 1, 2001, implements the consumer protection requirements of the GLB Act, which are codified at 12 USC 1831x. (See 65 *Fed. Reg.* 75841, December 4, 2000.) The regulation applies not only to the sale of insurance products or annuities by the bank, but also to activities of any person engaged in insurance product or annuity sales on behalf of the bank, as discussed in this guidance. The guidance is generally not applicable to debt-cancellation contracts and debt-suspension agreements, unless these products are considered to be insurance products by the state in which the sales activities are conducted.

The GLB Act permits state member banks that are not authorized by applicable state law to sell insurance directly to do so through a financial subsidiary.[3] A financial subsidiary engaged in insurance sales may be located wherever state

1. The term ''producer'' refers broadly to persons, partnerships, associations, limited liability corporations, etc., that hold a license to sell or solicit contracts of insurance to the public. Insurance agents and agencies are producers who, through a written contractual arrangement known as a direct appointment, represent one or more insurance underwriters. Independent agents and agencies are those producers that sell products underwritten by one or more insurance underwriters. Captive agents and agencies represent a specific underwriter and sell only its products. Brokers are producers that represent the purchaser of insurance and obtain bids from competing underwriters on behalf of their clients. State insurance laws and regulations often distinguish between an insurance agent and a broker; in practice, the terms are often used interchangeably.

2. The term ''risk assessment'' denotes the work product described in SR-97-24, ''Risk-Focused Framework for Supervision of Large Complex Institutions,'' and entails an analysis of (1) the level of inherent risk by type of risk (operational, legal, market, liquidity, credit, and reputation risk) for a business line or business function, (2) the adequacy of management controls over that business line or business function, and (3) the direction of the risk (increasing, decreasing, or stable).

3. Rules pertaining to state member bank financial subsid-

law permits the establishment and operation of an insurance agency. Such subsidiaries, however, would be subject to state licensing and other requirements.

The Federal Reserve is responsible for evaluating the consolidated risk profile of a state member bank. This reponsibility includes determining the risks posed to the state member bank from the insurance and annuity sales activities it conducts directly or indirectly, as well as determining the effectiveness of the bank's risk-management systems. However, the GLB Act also established a regulatory framework that is designed to ensure that the Federal Reserve coordinates with, and relies to the extent possible on information from, the state insurance authorities when it is supervising the insurance activities a state member bank conducts through a functionally regulated subsidiary.

Consistent with the Federal Reserve's risk-focused framework for supervising banking organizations, resources allocated to the review of insurance sales activities should be commensurate with the significance of the activities and the risk they pose to the bank. The scope of the review depends on the significance of the activity to the state member bank and the extent to which the bank is directly involved in the activity. Examiner judgment is required to tailor the reviews, as appropriate, on the basis of the legal, organizational, and risk-management structure of the state member bank's insurance and annuity sales activities and on other relevant factors.[4]

SUPERVISORY APPROACH FOR THE REVIEW OF INSURANCE AND ANNUITY SALES ACTIVITIES

Supervisory Objective

The primary objective for the review of a state member bank's insurance and annuity sales activities is to determine the level and direction of risk such activities pose to the state member bank. The review includes insurance and annuity sales activities the state member bank conducts directly (by or in conjunction with a subsidiary or affiliate) or through a third-party arrangement. Primary risks that may arise from insurance sales activities include operational, legal, and reputational risk. If the state member bank does not adequately manage these risks, they could have an adverse impact on its earnings and capital. The examiner should produce (1) a risk assessment that summarizes the level of inherent risk to the state member bank by risk category and (2) an assessment of the adequacy of board of directors' and management oversight of the insurance and annuity sales activities, including their internal control framework. For those state member banks selling insurance or annuity products, or that enter into arrangements under which another party sells insurance or annuity products at the bank's offices or on behalf of the bank, a second objective of the review is to determine the bank's compliance with the consumer protection provisions of the GLB Act and the CPSI regulation.

State Regulation of Insurance Activities

Historically, insurance activities have primarily been regulated by the states. In 1945, Congress passed the McCarran-Ferguson Act, which granted states the power to regulate most aspects of the insurance business. The McCarran-Ferguson Act states that "no act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any state for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance" (15 USC 1012(b)).

State regulation of insurance producers is centered on the protection of the consumer and consists primarily of licensing and continuing education requirements for producers. A producer generally must obtain a license from each state in which it sells insurance and for each product sold. Each state in which a producer sells insurance has regulatory authority over the producer's activities in the state.

The GLB Act does include several provisions that are designed to keep states from (1) unfairly regulating a bank to prevent it from engaging in

iaries are found in the Board's Regulation H (12 CFR 208.71–77).

4. See SR-02-01, "Revisions to Bank Holding Company Supervision Procedures for Organizations with Total Consolidated Assets of $5 Billion or Less," and section 1000.1 for a discussion of the Federal Reserve's risk-focused examinations and the risk-focused supervision program for community banking organizations. See also SR-97-24 and SR-97-25.

authorized insurance activities or (2) otherwise discriminating against banks engaged in insurance activities. These provisions are complex and beyond the scope of this guidance. However, the GLB Act generally does not prohibit a state from requiring a bank or bank employee engaged in insurance sales, solicitation, or cross-marketing activities to be licensed within the state.

State insurance regulatory authorities do not conduct routine, periodic examinations of an insurance producer. A state examination of an insurance producer is generally conducted only on an ad hoc basis and is primarily based on the volume and severity of consumer complaints. The state examination may also be based in part on the producer's market share and on previous examination findings. Additionally, a review of a producer would typically not assess its financial condition.

A state's market conduct examination of *insurance sales practices* is focused at the insurance-underwriter level.[5] The insurance underwriter is generally held accountable for compliance with state insurance laws to protect the consumer from the unfair sales practices of any producer that markets the insurance underwriter's products. Market conduct examinations of an insurance underwriter may potentially uncover a concern about a particular producer, such as a bank-affiliated producer.[6] However, in the past, a state insurance regulatory authority has not typically examined a producer unless the producer is owned by the insurance underwriter.

Generally, market conduct examinations include reviews of the insurance underwriters' complaint handling, producer licensing, policyholder service, and marketing and sales practices. Typically, a state authority will direct a corrective action for insurance sales activity at the underwriter. The states generally have specific guidance for their market conduct examinations of life, health, and property/casualty[7] lines of business—guidance that corresponds to regulations related to advertising, misrepresentations, and disclosures for these different business lines. The reports of examination issued by the state insurance departments are usually available to the public.

Because the underwriter, not the producer, is liable to the insured, the failure of an insurance producer generally would not result in financial loss to consumers or state guarantee funds. Consequently, there are no regulatory capital requirements for insurance producers, nor do states require regulatory reporting of financial statement data on insurance producers. While the underwriter is ultimately liable to the insured, in some instances, a producer and its owner may be held liable for misrepresentations, as well as for violations of laws and regulations.

Functional Regulation

Under the GLB Act, banking supervisors' reviews of insurance or securities activities conducted in a bank's functionally regulated subsidiary are not to be extensions of more traditional bank-like supervision. Rather, to the extent possible, bank supervisors are to rely on the functional regulators to appropriately supervise the insurance and securities activities of a functionally regulated subsidiary. A functionally regulated subsidiary includes any subsidiary of a bank that (1) is engaged in insurance activities and subject to supervision by a state insurance regulator or (2) is registered as a broker-dealer with the Securities and Exchange Commission. The GLB Act does *not* limit the Federal Reserve's supervisory authority with respect to a *bank* or the insurance activities conducted by a bank. The functional regulators for insurance sales activities, including the activities of insurance producers, consist of the insurance departments in each of the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, American Samoa, and Guam.

5. Generally, market conduct reviews of *insurance underwriters* are conducted on an ad hoc basis, triggered primarily by the volume and severity of consumer complaints, and are based on the underwriter's market share or on previous examination findings. In some states, however, market conduct reviews of insurance underwriters are conducted on a periodic, three- to five-year schedule.

6. The terms "insurance underwriter," "insurer," "insurance carrier," and "insurance company" are industry terms that apply similarly to the party to an insurance arrangement who undertakes to indemnify for losses, that is, the party that assumes the principal risk under the contract.

7. Property insurance indemnifies a person who has an interest in a physical property for loss of the property or the loss of its income-producing abilities. Casualty insurance is primarily concerned with the legal liability for losses caused by injury to persons or damage to the property of others. It may also include such diverse forms of insurance as crime insurance, boiler and machinery insurance, and aviation insurance. Many casualty insurers also underwrite surety bonds.

The GLB Act places certain limits on the ability of the Federal Reserve to examine, obtain reports from, or take enforcement action against a functionally regulated nondepository subsidiary of a state member bank. For purposes of these limitations, a subsidiary licensed by a state insurance department to conduct insurance sales activities is considered functionally regulated only with respect to its insurance activities and any activities incidental to these activities.[8]

The GLB Act indicates that the Federal Reserve must rely, to the fullest extent possible, on information obtained by the appropriate state insurance authority of a nondepository insurance agency subsidiary of a state member bank. In addition, the Federal Reserve may examine a functionally regulated subsidiary of a state member bank only in the following situations:

- The Federal Reserve has reasonable cause to believe that the subsidiary is engaged in activities that pose a material risk to an affiliated depository institution, as determined by the responsible Reserve Bank and Board staff.
- After reviewing relevant information (including information obtained from the appropriate functional regulator), it is determined that an examination is necessary to adequately understand and assess the banking organization's systems for monitoring and controlling the financial and operational risks that may pose a threat to the safety and soundness of an affiliated depository institution.
- On the basis of reports and other available information (including information obtained from the appropriate functional regulator), there is reasonable cause to believe that the subsidiary is not in compliance with a federal law that the Federal Reserve has specific jurisdiction to enforce with respect to the subsidiary (including limits relating to transactions with affiliated depository institutions), and the Federal Reserve cannot assess such compliance by examining the state member bank or other affiliated depository institution.

Other similar restrictions limit the ability of the Federal Reserve to obtain a report directly from, or take enforcement action against, a functionally regulated nonbank subsidiary of a state member bank. These GLB Act limitations do *not* apply to a state member bank even if the state member bank is itself licensed by a state insurance regulatory authority to conduct insurance sales activities.

Staff who are conducting reviews of state member bank insurance or annuity sales activities should be thoroughly familiar with SR-00-13, which provides guidance on reviews of functionally regulated state member bank subsidiaries. Reserve Bank staff may conduct an examination of a functionally regulated subsidiary, or request a specialized report from a functionally regulated subsidiary, only after obtaining approvals from the appropriate staff of the Board's Division of Banking Supervision and Regulation.

When preparing or updating the risk assessment of a state member bank's insurance or annuity sales activities, Federal Reserve staff, when appropriate, should coordinate their activities with the appropriate state insurance authorities. The Federal Reserve's supervision of state member banks engaged in insurance sales activities is not intended to replace or duplicate the regulation of insurance activities by the appropriate state insurance authorities.

Information Sharing with the Functional Regulator

The Federal Reserve and the National Association of Insurance Commissioners (NAIC) approved a model memorandum of understanding (MOU) on the sharing of confidential information between the Federal Reserve and individual state insurance departments.[9] The Board also approved the delegation of authority to the Board's general counsel to execute agreements with individual states, based on this MOU. Examiners should follow required Board administrative procedures before sharing any confidential information with a state insurance regulator. (These procedures generally require Federal Reserve staff to identify and forward to Board staff for review any confidential information that may be appropriate to share with the applicable

8. For example, if a state member bank subsidiary engages in mortgage lending and is also licensed as an insurance agency, it would be considered a functionally regulated subsidiary only to the extent of its insurance sales activities.

9. The NAIC is the organization of insurance regulators from the 50 states, the District of Columbia, and the four U. S. territories. The NAIC provides a forum for the development of uniform policy among the states and territories. The NAIC is not a governmental or regulatory body.

state insurance regulator concerning insurance sales activities conducted by state member banks.) The Board's Division of Consumer and Community Affairs CP Letter 2001-11 outlines the procedures for sharing consumer complaint information with state insurance regulators.

STATUTORY AND REGULATORY REQUIREMENTS AND POLICY GUIDANCE

Privacy Rule and the Fair Credit Reporting Act

State member banks that sell insurance to consumers must comply with the privacy provisions under title V of the GLB Act (12 USC 6801–6809), as implemented by the Board's Regulation P (12 CFR 216) (the privacy rule). Functionally regulated state member bank nonbank insurance agency subsidiaries are not covered by the Federal Reserve's privacy rule; however, they must comply with the privacy regulations (if any) issued by their relevant state insurance regulator.

The privacy rule regulates a state member bank's treatment of nonpublic personal information about a "consumer," an individual who obtains a financial product or service (such as insurance) from the institution for personal, family, or household purposes. The privacy rule generally requires a bank to provide a notice to each of its customers that describes its privacy policies and practices no later than when the bank establishes a business relationship with the customer. The privacy rule also generally prohibits a bank from disclosing any nonpublic personal information about a consumer to any nonaffiliated third party, unless the bank first provides to the consumer a privacy notice and a reasonable opportunity to prevent (or "opt out" of) the disclosure, and the consumer does not opt out. The privacy rule permits a financial institution to provide a joint notice with one or more of its affiliates or other financial institutions, as identified in the privacy notice itself, provided that the notice is accurate with respect to the institution and the other institutions.

While the privacy rule applies to the sharing of nonpublic personal information by a bank with nonaffiliated third parties, the sharing of certain consumer information with affiliates or nonaffiliates may be subject to the Fair Credit Reporting Act (FCRA) as well. For example, under the FCRA, if a bank wants to share with its insurance subsidiary information from a credit report or from a consumer application for credit (such as the consumer's assets, income, or marital status), the bank must first notify the consumer about the intended sharing and give the consumer an opportunity to opt out. The same rules would apply to an insurance company that wants to share information from credit reports or from applications for insurance with an affiliate or a third party.

Anti-Tying Prohibitions

Federal law (section 106(b) of the BHC Act Amendments of 1970 (12 USC 1972(b))) generally prohibits a bank from requiring that a customer purchase a product or service from the bank or an affiliate as a prerequisite to obtaining another product or service (or a discount on the other product or service) from the bank. This prohibition applies whether the customer is retail or institutional, or whether the transaction is on bank premises or off premises. For example, a state member bank may not require that a customer purchase insurance from the bank or a subsidiary or affiliate of the bank in order to obtain a loan from the bank (or a reduced interest rate on the loan).[10]

Policy Statement on Income from Sale of Credit Life Insurance

The Federal Reserve Board's Policy Statement on Income from Sale of Credit Life Insurance (see the *Federal Reserve Regulatory Service* at 3-1556) sets forth the principles and standards that apply to a bank's sales of credit life insurance and the limitations that apply to the receipt of income from those sales by certain individuals and entities associated with the bank. See also the examination procedures related to this policy statement in section 2130.3.

10. See section 2040.1 and "Tie-In Considerations of the BHC Act," section 3500.0, of the *Bank Holding Company Supervision Manual.*

RISK-MANAGEMENT PROGRAM

Elements of a Sound Insurance or Annuity Sales Program

A state member bank engaged in insurance or annuity sales activities should—

- conduct insurance sales programs in a safe and sound manner;
- have appropriate written policies and procedures in place that are commensurate with the volume and complexity of its insurance sales activities;
- obtain its board of directors' approval of the scope of the insurance and annuity sales program and of written policies and procedures for the program;
- effectively oversee the sales program activities, including third-party arrangements;
- have an effective, independent internal audit and compliance program;
- appropriately train and supervise the employees conducting insurance and annuity sales activities;
- take reasonable precautions to ensure that disclosures to customers for insurance and annuity sales and solicitations are complete and accurate and are in compliance with applicable laws and regulations;
- ensure compliance with all applicable federal, state, or other jurisdiction regulations, including compliance with sections 23A and 23B of the Federal Reserve Act as that act applies to affiliate transactions; and
- have controls in place to ensure accurate and timely financial reporting.

Every state member bank conducting insurance or annuity sales activities should have appropriate, board-approved policies, procedures, and controls in place to monitor and ensure that it complies with both federal and state regulatory requirements. Consistent with the principle of functional regulation, the Federal Reserve will rely primarily on the appropriate state insurance authorities to monitor and enforce compliance with applicable state insurance laws and regulations, including state consumer protection laws and regulations governing insurance sales.

Sales Practices and Handling of Customer Complaints

Every state member bank engaged in insurance or annuity sales activities should have board-approved policies and procedures for handling customer complaints related to these sales. The customer complaint process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. A state member bank's board of directors and senior management should also review complaints if the complaints involve significant compliance issues that may pose a risk to the state member bank.

Third-Party Arrangements

State member banks, to the extent permitted by applicable law, may enter into agreements with third parties, including unaffiliated agents or agencies, to sell insurance or annuities or provide expertise and services that otherwise would have to be developed in-house. Many banks hire third parties to assist in establishing an insurance program or to train their own insurance staff. A bank may also find it advantageous to offer more specialized insurance products through a third-party arrangement.

A state member bank's management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement to conduct insurance or annuity sales with the third party. The review should include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the state member bank, which includes compliance with applicable consumer protection laws and regulations.

The state member bank's board of directors or its designated committee should approve any agreements with third parties. Agreements should outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the state member bank's office space, equipment, and personnel. If an arrangement includes dual employees (for example, bank employees who are also employed by an independent third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable. The agreement should authorize the banking organization to monitor the third party's compliance with its agreement, as well as authorize the bank to have access to third-party records considered necessary to evaluate compliance. A state member bank that contracts with a functionally regulated third party should obtain from and review, as appropriate, any relevant, publicly available regulatory reports of examination of the third party.[11] Finally, the agreement should provide for indemnification of the institution by the unaffiliated third party for any losses caused by the conduct of the third party's employees in connection with its sales activities.

The state member bank is responsible for ensuring that any third party or dual employee selling insurance at or on behalf of the bank is appropriately trained either by the bank or the third party with respect to compliance with the minimum disclosures and other requirements of the CPSI regulation and applicable state regulations. The banking organization should obtain and review copies of third-party training and compliance materials to monitor the third party's performance of its disclosure and training obligations.

Designation, Training, and Supervision of Personnel

A state member bank hiring personnel to sell insurance or annuities should investigate the backgrounds of the prospective employees. When a candidate for employment has previous insurance industry experience, the state member bank should have procedures to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators.[12]

11. The reports of examination issued by state insurance regulators are generally public documents. Many states do not conduct periodic examinations of insurance sales activities.

12. Information from the states on the issuance and termination of producer licenses and on producers' compliance with continuing education requirements is available from the NAIC database known as the National Insurance Producer Registry (NIPR).

The state member bank should require its own insurance or annuity sales personnel or third-party sales personnel selling at or on behalf of the bank to receive appropriate training and licensing. Training should cover appropriate policies and procedures for the bank's sales of insurance and annuity products. Personnel who are referring potential or established customers to a licensed insurance producer should also be trained to ensure that referrals are made in conformance with the CPSI regulation, if applicable. The training should also include procedures and guidance to ensure that an unlicensed or referring individual cannot be deemed to be acting as an insurance agent that is subject to licensing requirements.

When insurance or annuities are sold by a state member bank or third parties at an office of, or on behalf of, the organization, the institution should have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as for supervising the referral activities of bank employees not authorized to sell these products. A state member bank also should designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation, if applicable.

Compliance

State member banks should have policies and procedures to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations (including the CPSI regulation for sales conducted by or on behalf of the state member bank) and the institution's internal policies and procedures. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. For example, sales-compensation programs should be conducted in a manner that would not expose the bank to undue legal or reputation risks. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the banking organization.

The compliance function should be conducted independently of the insurance and annuity product sales and management activities. Compliance personnel should determine the scope and frequency of their reviews, and findings of compliance reviews should be reported directly to the state member bank's board of directors or to its designated board committee.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

A risk assessment of insurance activities may be accomplished in the course of conducting a regularly scheduled state member bank examination or as a targeted review. The purpose of preparing the risk assessment is to determine the level and direction of risk to the bank arising from its insurance and annuity sales activities. Risks to state member banks engaged in insurance and annuity sales programs consist primarily of legal, reputational, and operational risk, all of which may lead to financial loss. After completing the risk assessment, if material concerns remain, the Board's Division of Banking Supervision and Regulation staff should be consulted for further guidance.

Legal and reputational risk may arise from a variety of sources, such as fraud; noncompliance with statutory or regulatory requirements, including those pertaining to the handling of premiums collected on behalf of the underwriter; claims processing; insurance and annuity sales practices; and the handling of ''errors and omissions'' claims.[13] Other sources of legal and reputational risk may arise from failing to safeguard nonpublic customer information, a high volume of customer complaints, or public regulatory sanctions against a producer.

Legal and reputational risks may also arise from an agent's obligation to provide a customer with products that are suited to the customer's particular needs and are priced and sold in accordance with state regulations. Additionally, an agent or agency may be liable for failing to carry out the appropriate paperwork to bind a policy that it has sold to a customer, or for making an error in binding the policy. State insurance departments generally are permitted by law to suspend or revoke a producer's license and assess monetary penalties against a producer if warranted.

Operational risk may arise from errors in processing sales-related information or from a lack of appropriate controls over systems or staff responsible for carrying out the insurance or annuity sales activities. Additionally, state member banks that have recently commenced insurance or annuity sales activities, or that are expanding their insurance or annuity sales business, also are exposed to risk arising from inadequate strategic and financial planning associated with the activities, which could result in financial loss. Examiners should be attuned to risks that may arise from inadequate controls over insurance activities, a rapid expansion of the insurance or annuity sales programs offered by the state member bank, the introduction of new products or delivery channels, and legal and regulatory developments.

Operational risk may arise from inadequate premium-payment procedures and trust-account-balance administration by an agency. When the insurance agency bills the insured, the agent must comply with requirements for forwarding the payments to the insurer and for safekeeping the funds. Inadequate internal controls over this activity may result in the inappropriate use of these funds by the agent or agency. The state member bank should ensure that appropriate controls are in place to verify that all funds that are owed to the insurer or the insured are identified in the trust account and that the account is in balance.

When conducting a risk assessment, the examiner should first obtain relevant information to determine the existence and scale of insurance or annuity sales activity. Such information is available in the state member bank's Uniform Bank Performance Report (UBPR) and in other System reports on insurance activities. Relevant reports, including applicable balance sheets and income statements for the insurance and annuity sales activities, may also be obtained from the state member bank. When preparing a risk assessment for an insurance or annuity sales activity that is conducted by a functionally regulated nonbank subsidiary of a state member bank, examiners should rely, to the fullest extent possible, on information available from the state member bank and the appropriate state insurance regulator for the subsidiary. If information that is needed to assess the risk cannot be obtained from the state member bank or the

13. Errors and omissions insurance indemnifies the insured against loss sustained because of an error or oversight by the insured. For instance, an insurance agency generally purchases this type of coverage to protect itself against such things as failing to issue a policy.

applicable functional regulator, the examiner should consult with the appropriate designated Board staff. Requests should not be made directly to a functionally regulated nonbank insurance and annuity sales subsidiary of a state member bank without first obtaining approval from the appropriate Board staff.

CONSUMER PROTECTION IN SALES OF INSURANCE RULES

Overview of the CPSI Regulation

The CPSI regulation is applicable to all insured depository institutions.[14] The regulation, however, generally does not apply to nonbank affiliates or subsidiaries of a state member bank unless the company engages in the retail sale of insurance products or annuities at an office of, or on behalf of, an insured depository institution. Interpretations of the regulation issued by the federal banking agencies are found in appendix A of this section. Federal Reserve examiners are responsible for reviewing state member banks' compliance with the regulation.

The regulation applies to the retail sale of insurance products and annuities by banks or by any other person at an office of a bank, or acting on behalf of a bank. For purposes of the CPSI regulation, "office" means the premises of the bank where retail deposits are accepted. The regulation applies only to the retail sale of insurance or annuity products—that is, when the insurance is sold or marketed to an individual primarily for personal, family, or household purposes.

Misrepresentations Prohibited

The regulation prohibits a bank or other covered person from engaging in any practice or using any advertisement at any office of, or on behalf of, the bank or a subsidiary of the bank if the practice or advertisement could mislead any person or otherwise cause a reasonable person to erroneously believe—

- that the insurance product or annuity is backed by the federal government or the bank or is insured by the Federal Deposit Insurance Corporation (FDIC);
- that an insurance product or annuity does not have investment risk, including the potential that principal may be lost and the product may decline in value, when in fact the product or annuity does have such risks; or
- in the case of a bank or subsidiary of the bank at which insurance products or annuities are sold or offered for sale, that (1) the bank may condition approval of an extension of credit to a consumer by the bank or subsidiary on the purchase of an insurance product or annuity from the bank or a subsidiary of the bank, and (2) the consumer is not free to purchase the insurance product or annuity from another source.

The regulation also incorporates the anti-tying provisions of section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972). Additionally, banks are prohibited from selling life or health insurance products if the status of the applicant or insured as a victim of domestic violence or as a provider of services to domestic violence victims is considered as a factor in decision making on the product, except as expressly authorized by state law.

Insurance Disclosures

The CPSI regulation also requires that a bank or a person selling insurance at an office of, or on behalf of, a bank make the following affirmative disclosures (to the extent accurate), both orally and in writing, before the completion of the initial sale of an insurance product or an annuity to a consumer. However, sales by mail or, if the consumer consents, via electronic media (such as the Internet) do not require oral disclosure.

- The insurance product or annuity is not a deposit or other obligation of, or guaranteed by, the bank or an affiliate of the bank.
- The insurance product or annuity is not insured by the FDIC or any other U.S. government agency, the bank, or (if applicable) an affiliate of the bank.
- The insurance product or annuity, if applicable, has investment risk, including the possible loss of value.

14. The CPSI regulation applies to all federally insured depository institutions, including all federally chartered U.S. branches and state-chartered insured U.S. branches of foreign banking organizations.

For telephone sales, written disclosures must be mailed within three business days. The above disclosures must be included in advertisements and promotional materials for insurance products and annuities, unless the advertisements or promotional materials are of a general nature and describe or list the nature of services or products offered by the bank. Disclosures must be conspicuous and readily understandable.

Credit Disclosures

When an application for credit is made in connection with the solicitation, offer, or sale of an insurance product or annuity, the consumer must be notified that the bank may not condition the extension of credit on either (1) the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates or (2) the consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product or annuity from an unaffiliated entity. These disclosures must be made both orally and in writing; however, applications taken by mail or, if the consumer consents, via electronic media, do not require oral disclosure. For telephone applications, the written disclosure must be mailed within three business days. The disclosures must be conspicuous and readily understandable.

Consumer Acknowledgment

The bank must obtain written or electronic acknowledgments of the consumer's receipt of the disclosures described above at the time they are made or at the completion of the initial purchase. For telephone sales, the bank must receive an oral acknowledgment and make a reasonable effort to obtain a subsequent written or electronic acknowledgment.

Location

Insurance and annuity sales activities must take place, to the extent practicable, in an area physically segregated from one where retail deposits are routinely accepted from the general public (such as teller windows). The bank must clearly identify and delineate areas where insurance and annuity sales activities occur.

Referrals

Any person who accepts deposits from the public in an area where deposits are routinely accepted may refer a consumer to a qualified person who sells insurance products or annuities only if the person making the referral receives no more than a one-time, nominal fee of a fixed dollar amount for the referral. The amount of the referral fee may *not* depend on whether a sale results from the referral.

Qualifications

A bank may not permit any person to sell or offer insurance products or annuities at its office or on its behalf, unless that person is at all times properly qualified and licensed under applicable state law for the specific products being sold or recommended.

Relationship of the CPSI Regulation to State Regulation

The GLB Act contains a legal framework for determining the effect of the CPSI regulation on state laws governing the sale of insurance, including state consumer protection standards. In general, if a state has legal requirements that are inconsistent with, or contrary to, the CPSI regulation, initially the federal regulation does not apply in the state. However, the federal banking agencies may, after consulting with the state involved, decide to preempt any inconsistent or contrary state laws if the agencies find that the CPSI regulation provides greater protections than the state laws. It is not expected that there will be significant conflict between state and federal laws in this area. If the consumer protection laws of a particular state appear to be inconsistent with and less stringent (that is, provide less consumer protection) than the CPSI regulation, examiners should inform the staff of the Board's Division of Banking Supervision and Regulation.

Relationship to Federal Reserve Guidance on the Sale of Nondeposit Investment Products

When a bank sells insurance products or annuities that also are securities (such as variable life insurance annuities), it must conform with the applicable Federal Reserve and interagency guidance pertaining to a bank's retail sales of nondeposit investment products (NDIPs).[15] If the CPSI regulation and the guidance pertaining to NDIPs conflict, the CPSI regulation prevails.

Examining a State Member Bank for Compliance with the CPSI Regulation

Examinations for compliance with the CPSI regulation should be conducted consistent with the risk-focused supervisory approach when a state member bank sells insurance products or annuities directly, or when a third party sells insurance or annuities at or on behalf of, a state member bank. To the extent practicable, the examiner should conduct the review at the state member bank. In certain instances, however, the examiner's review at the state member bank may identify potential supervisory concerns about the state member bank's compliance with the CPSI regulation as it pertains to insurance or annuities sales conducted by a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance products or annuities at or on behalf of the state member bank.

If the examiner determines that an on-site review of a functionally regulated nonbank affiliate or subsidiary of the state member bank is appropriate to adequately assess the state member bank's compliance with the CPSI regulation, the examiner should discuss the situation with staff of the Board's Division of Banking Supervision and Regulation. The approval of the Division of Banking Supervision and Regulation's officer that is responsible for the supervisory policy and examination guidance pertaining to insurance and annuity sales activities should be obtained before examining or requesting any information directly from a functionally regulated nonbank affiliate or subsidiary of the state member bank that is selling insurance or annuity products at or on behalf of the state member bank.

The examination guidelines described in section 4043.3 apply to retail sales, solicitations, advertisements, or offers of insurance products and annuities by any state member bank or any other person that is engaged in such activities at an office of the bank or on behalf of the state member bank. For purposes of the CPSI regulation, activities "on behalf of a state member bank" include activities in which a person, whether at an office of the bank or at another location, sells, solicits, advertises, or offers an insurance product or annuity and in which at least one of the following applies:

- The person represents to a consumer that the sale, solicitation, advertisement, or offer of any insurance product or annuity is by or on behalf of the bank.
- The bank refers a consumer to a seller of insurance products or annuities, and the bank has a contractual arrangement to receive commissions or fees derived from the sale of an insurance product or annuity resulting from the bank's referral.
- Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the bank.

APPENDIX A—JOINT INTERPRETATIONS OF THE CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

In response to a banking association's inquiries, the federal banking agencies jointly issued interpretations regarding the Consumer Protection in Sales of Insurance (CPSI) regulation.[1] A joint statement, issued on August 17, 2001, contains responses to a set of questions relating to disclosure and acknowledgment, the scope of applicability of the regulation, and compliance. Additionally, a February 28, 2003, joint statement responded to a request to clarify whether the disclosure requirements apply to renewals of pre-existing insurance policies sold before Octo-

15. Interagency Statement on Retail Sales of Nondeposit Investment Products, February 17, 1994. See SR-94-11.

1. These letters, issued jointly by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, may be accessed on these agencies' web sites.

ber 1, 2001, the effective date of the regulation. The issues raised and the banking agencies' responses are summarized below.

Disclosures

Credit Disclosures

A bank or other person who engages in insurance sales activities at an office of, or on behalf of, a bank (''a covered person'') must make the credit disclosures set forth in the regulation if a consumer is solicited to purchase insurance while the consumer's loan application is pending. A consumer's application for credit is still ''pending'' for purposes of the regulation if the depository institution has approved the consumer's loan application but not yet notified the consumer. Until the consumer is notified of the loan approval, the covered person must provide the credit disclosures if the consumer is solicited, offered, or sold insurance.

Disclosures for Sales by Mail and Telephone

The regulation requires a covered person to provide oral disclosures and to obtain an oral acknowledgment of these disclosures when sales activities are conducted by telephone. This requirement applies regardless of whether the consumer will also receive and acknowledge written disclosures in person, through the mail, or electronically.

Use of Short-Form Insurance Disclosures

There is no short form for the credit disclosures. A depository institution, however, may use the short-form insurance disclosures set forth below in visual media (such as television broadcasting, ATM screens, billboards, signs, posters, and written advertisements and promotional materials):

- NOT A DEPOSIT
- NOT FDIC-INSURED
- NOT INSURED BY ANY FEDERAL GOVERNMENT AGENCY
- NOT GUARANTEED BY THE BANK
- MAY GO DOWN IN VALUE

Acknowledgment of Disclosures

Reasonable efforts to obtain written acknowledgment. The banking agencies have not prescribed any steps that must be taken for a depository institution's efforts to obtain a written acknowledgment to be deemed ''reasonable'' in a transaction conducted by telephone. Examples of reasonable efforts, however, include—

- providing the consumer with a return-addressed envelope or similar means to facilitate the consumer's return of the written acknowledgment,
- making a follow-up phone call or contact,
- sending a second mailing, or
- similar actions.

The covered person should (1) maintain documentation that the written disclosures and the request for written acknowledgment of those disclosures were mailed to the consumer and (2) should record his or her efforts to obtain the signed acknowledgment. The ''reasonable efforts'' policy exception for telephone sales does not apply to other types of transactions, such as mail solicitations, in which a covered person must obtain from the consumer a written (in electronic or paper form) acknowledgment.

Appropriate form or format for acknowledgment provided electronically. Electronic acknowledgments are not required to be in a specific format but must be consistent with the provisions of the CPSI regulation applicable to consumer acknowledgments. That is, the electronic acknowledgment must establish that the consumer has acknowledged receipt of the credit and insurance disclosures, as applicable.

Retention of acknowledgments by an insurance company. If an insurance company provides the disclosures and obtains the acknowledgment on behalf of a depository institution, the insurance company may retain the acknowledgment. The depository institution is responsible for ensuring that sales made ''on behalf of'' the depository institution are in compliance with the CPSI regulation. An insurance company may maintain documentation showing compliance with the CPSI regulation, but the depository institution should have access to such records and the records should be readily available for review by examiners.

Form of written acknowledgment. There is no prescribed form for the written acknowledgment. The regulation requires, however, that a covered person obtain the consumer's acknowledgment of receipt of the complete insurance and credit disclosures.

Timing of acknowledgment receipt. A covered person must obtain the consumer's acknowledgment either at the time a consumer receives disclosures or at the time of the initial purchase of an insurance product.

Oral acknowledgment of oral disclosure. The CPSI regulation does not prescribe any specific wording for an oral acknowledgment. However, if a covered person has made the insurance and credit disclosures orally, an affirmative response to the question "Do you acknowledge that you received this disclosure?" is acceptable.

Scope of the CPSI Regulation

Applicability to Private Mortgage Insurance

Depending on the nature of a depository institution's involvement in an insurance sales transaction, the CPSI regulation may cover sales of private mortgage insurance. If the depository institution itself purchases the insurance to protect its interest in mortgage loans it has issued and merely passes the costs of the insurance on to the mortgage borrowers, the transaction is not covered by the regulation. If, however, a consumer has the option of purchasing the private mortgage insurance and (1) the depository institution offers the private mortgage insurance to a consumer or (2) any other person offers the private mortgage insurance to a consumer at an office of a depository institution, or on behalf of a depository institution, the transaction would be covered by the regulation.

Applicability to Federal Crop Insurance

The CPSI regulation does not apply to federal crop insurance that is sold for commercial or business purposes. However, if the crop insurance is purchased by an individual primarily for family, personal, or household purposes, it would be covered.

Solicitations and Applications Distributed Before, but Returned After, the Effective Date of the CPSI Regulation

Direct-mail solicitations and "take-one" applications that are distributed on or after October 1, 2001, must comply with the CPSI regulation. If a consumer seeks to purchase insurance after the effective date of the regulation in response to a solicitation or advertisement that was distributed *before* that date, the depository institution would be in compliance with the regulation if the institution provides the consumer, before the initial sale, with the disclosures required by the regulation. These disclosures must be both written and oral, except that oral disclosures are not required if the consumer mails in the application.

Renewals of Insurance

Renewals of insurance are not subject to the disclosure requirements (see "Disclosures" above) but are subject to other requirements of the CPSI regulation. A "renewal" of insurance means continuation of coverage involving the same type of insurance for a consumer as issued by the same carrier. A renewal need not be on the same terms and conditions as the original policy, provided that the renewal does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the time of the initial sale. An upgrade in coverage at a time when a policy is not up for renewal would be treated as a renewal, provided that the solicitation and sale of the upgrade does not involve a different type of insurance and the consumer has previously received the disclosures required by the regulation at the initial sale.

Disclosures Required with Renewals of Insurance Coverage

The banking agencies' interpretations clarified that the CPSI regulation does not *mandate* disclosures for renewals of policies sold before October 1, 2001. Accordingly, the regulation does not require the disclosures to be furnished at the time of renewal of a policy, including a pre-existing policy. However, renewals are subject to the other provisions of the regulation. Moreover, the banking agencies would expect that, consistent with applicable safety-and-soundness requirements, depository institutions would take reasonable steps to avoid customer confusion in connection with renewals of pre-existing policies.

"On-Behalf-of" Test and Use of Corporate Name or Logo

Under the CPSI regulation, an affiliate of a bank is not considered to be acting "on behalf of" a bank simply because the affiliate's marketing or other materials use a corporate name or logo that is common to the bank and the affiliate. In general, this exclusion applies even if a bank and its parent holding company have a similar, but not identical, name. For example, if the names of all of the affiliates of a bank holding company share the words "First National," an affiliate would not be considered to be engaged in an activity "on behalf of" an affiliated bank simply by using the terms "First National" as part of a corporate logo or identity. The affiliate would, however, be considered to be acting "on behalf of" an affiliated bank if the name of the bank (for example, "First National Bank") appears in a document as the seller, solicitor, advertiser, or offeror of insurance. A transaction also would be covered if it occurs on the premises of a depository institution or if one of the other prongs of the "on-behalf-of" test is met.

Compliance

Appropriate Documentation of an Oral Disclosure or Oral Acknowledgment

There is no specific documentation requirement for oral disclosures or acknowledgments. However, other applicable regulatory reporting standards would apply. Appropriate documentation of an oral disclosure would clearly show that the covered person made the credit and insurance disclosures to a consumer. Similarly, appropriate documentation of an oral acknowledgment would clearly show that the consumer acknowledged receiving the credit and insurance disclosures. For example, a tape recording of the conversation (where permitted by applicable laws) in which the covered person made the oral disclosures and received the oral acknowledgment would be acceptable. Another example would be a contemporaneous checklist completed by the covered person to indicate that he or she made the oral disclosures and received the oral acknowledgment. A contemporaneous note to the consumer's file would also be adequate. The documentation should be maintained in the consumer's file so that it is accessible to examiners.

Setting for Insurance Sales

A depository institution must identify the areas where insurance sales occur and must clearly delineate and distinguish those areas from areas where the depository institution's retail deposit-taking activities occur. Although the banking agencies did not define how depository institutions could "clearly delineate and distinguish" insurance areas, signage or other means may be used.

APPENDIX B—GLOSSARY

For additional definitions of insurance terms, see section 4040.1.

Accident and health insurance. A type of coverage that pays benefits in case of sickness, accidental injury, or accidental death. This coverage may provide for loss of income when the insured is disabled and provides reimbursement for medical expenses when the insured is ill. The insurance can provide for debt payment if it is taken out in conjunction with a loan. (See *Credit life insurance.*)

Actuary. A professional whose function is to calculate statistically various estimates for the field of insurance, including the estimated risk of loss on an insurable interest and the appropriate level for premiums and reserves.

Admitted insurer. An insurance company licensed by a state insurance department to underwrite insurance products in that state.

Agency contract (or agreement). An agreement that establishes the contractual relationship between an agent and an insurer.

Agent. A licensed insurance company representative under contract to one or more insurance companies. Depending on the line of insurance represented, an agent's power may include soliciting, advertising, and selling insurance; collecting premiums; claims processing; and effecting insurance coverage on behalf of an insurance underwriter. Agents are generally compensated by commissions on policies sold, although some may receive salaries.

- *Captive or exclusive agent.* An agent who represents a single insurer.
- *General agent.* An agent who is contractually awarded a specific geographic territory for an individual insurance company. They are responsible for building their own agency and usually represent only one insurer. Unlike exclusive agents, who usually receive a salary in addition to commissions, general agents are typically compensated on a commission basis only.
- *Independent agent.* An agent who is under contractual agreements with at least two different insurers. Typically, all of the independent agent's compensation originates from commissions.

Aggregate excess-of-loss reinsurance. A form of ''excess-of-loss'' reinsurance that indemnifies the ceding company against the amount by which all of the ceding company's losses incurred during a specific period (usually 12 months) exceed either (1) a predetermined dollar amount or (2) a percentage of the company's subject premiums. This type of contract is also commonly referred to as *stop-loss reinsurance* or *excess-of-loss ratio reinsurance.*

Allied lines. Various insurance coverages for additional types of losses and against losses by additional perils. The coverages are closely associated with and usually sold with fire insurance. Examples include coverage against loss by perils other than fire, coverage for sprinkler-leakage damage, and business-interruption coverage.

Annuity. A contract that provides for a series of payments payable over an individual's life span or other term, on the basis of an initial lump-sum contribution or series of payments made by the annuitant into the annuity during the accumulation phase of the contract.

- *Fixed-annuity contracts* provide for payments to annuitants at fixed, guaranteed minimum rates of interests.
- *Variable-annuity contracts* provide for payments based on the performance of annuity investments. Variable-annuity contracts are usually sold based on a series of payments and offer a range of investment or funding options, such as stocks, bonds, and money market fund investments. The annuity principal and the investment return are not guaranteed as they depend on the performance of the underlying funding option.

Annuity payments may commence with the execution of the annuity contract (*immediate annuity*) or may be deferred until some future date (*deferred annuity*).

Assigned risk. A risk that is not usually acceptable to insurers and is therefore assigned to a group of insurers who are required to share in the premium income and losses, in accordance with state requirements, in order for the insurer to sell insurance in the state.

Assignment. The legal transfer of one person's interest in an insurance policy to another person or business.

Bank-owned life insurance (BOLI). Life insurance purchased and owned by a bank to fund its exposure arising from employee compensation and benefit programs. In a typical BOLI program, a bank insures a group of employees; pays the life insurance policy premiums; owns the cash values of the policies, which are booked on the bank's balance sheet as ''other assets''; and is the beneficiary of the policies upon the death of any insured employee or former employee. (See SR-04-19 and section 4042.1.)

Beneficiary. The person or entity named in an insurance policy as the recipient of insurance proceeds upon the policyholder's death or when an endorsement matures. A revocable beneficiary can be changed by the policyholder at any time. An irrevocable beneficiary can be changed by the policyholder only with the written permission of the beneficiary.

Binder. A written or oral agreement, typically issued by an insurer, agent, or broker for property and casualty insurance, to indicate acceptance of a person's application for insurance and to provide interim coverage pending the insurance company's issuance of a binding policy.

Blanket bond. Coverage for an employer for loss incurred as a result of employee dishonesty.

Boiler and machinery insurance. Insurance against the sudden and accidental breakdown of boilers, machinery, and electrical equipment, including coverage for damage to the equipment and property damage, including the property of others. Coverage can be extended to cover consequential losses, including loss from interruption of business.

Broker. A person who represents the insurance buyer in the purchase of insurance. Brokers do not have the power to bind an insurance company to an insurance contract. Once a contract is accepted, the broker is compensated for the transaction through a commission from the insurance company. An individual may be licensed as both a broker and an agent.

Bulk reinsurance. A transaction sometimes defined by statute as any quota-share, surplus aid, or portfolio reinsurance agreement through which an insurer assumes all or a substantial portion of the liability of the reinsured company.

Captive insurer. An insurance company established by a parent firm to insure or reinsure its own risks or the risks of affiliated companies. A captive may also underwrite insurable risks of unaffiliated companies, typically the risks of its customers or employees. A captive insurer may underwrite credit life or private mortgage insurance (third-party risks) related to its lending activities.

Cash surrender value of life insurance. The amount of cash available to a life insurance policyholder upon the voluntary termination of a life insurance policy before it becomes payable by death or maturity.

Casualty insurance. Coverage for the liability arising from third-party claims against the insured for negligent acts or omissions causing bodily injury or property damage.

Cede. To transfer to a reinsurer all or part of the insurance or reinsurance risk underwritten by an insurance company.

Ceding commission. The fee paid to a reinsurance company for assuming the risk of a primary insurance company.

Ceding company (also cedant, reinsured, reassured). The insurer that transfers all or part of the insurance or reinsurance risk it has underwritten to another insurer or reinsurer via a reinsurance agreement.

Cession. The amount of insurance risk transferred to the reinsurer by the ceding company.

Churning. The illegal practice wherein a customer is persuaded to unnecessarily cancel one insurance policy in favor of buying a purportedly superior policy, often using the cash surrender value of the existing policy to pay the early premiums of the new policy. In such a transaction, the salesperson benefits from the additional commission awarded for booking a new policy.

Claim. A request for payment of a loss under the terms of a policy. Claims are payable in the manner suited to the insured risk. Life, property, casualty, health, and liability claims generally are paid in a lump sum after the loss is incurred. Disability and loss-of-time claims are paid periodically during the period of disability or through a discounted lump-sum payment.

Coinsurance. A provision in property and casualty insurance that requires the insured to maintain a specified amount of insurance based on the value of the property insured. Coinsurance clauses are also found in health insurance and require the insured to share a percentage of the loss.

Combination-plan reinsurance. A reinsurance agreement that combines the excess-of-loss and the quota-share forms of coverage within one contract, with the reinsurance premium established as a fixed percentage of the ceding company's subject premium. After deducting the excess recovery on any one loss for one risk, the reinsurer indemnifies the ceding company on the basis of a fixed quota-share percentage. If a loss does not exceed the excess-of-loss retention level, only the quota-share coverage applies.

Commission. The remuneration paid by insurance carriers to insurance agents and brokers for the sale of insurance and annuity products.

Comprehensive personal liability insurance. A type of insurance that reimburses the policyholder if he or she becomes liable to pay money for damage or injury he or she has caused to others. This coverage does not include automobile liability but does include almost every activity of the policyholder, except business operations.

Contractholder. The person, entity, or group to whom an annuity is issued.

Credit for reinsurance. A statutory accounting procedure, set forth under state insurance regulations, that permits a ceding company to treat amounts due from reinsurers as assets, or as offsets to liabilities, on the basis of the reinsurer's status.

Credit life insurance. A term insurance product issued on the life of a debtor that is tied to repayment of a specific loan or indebtedness. Proceeds of a credit life insurance policy are used to extinguish remaining indebtedness at the time of the borrower's death. The term is applied broadly to other forms of credit-related insurance that provide for debt satisfaction in the event of a borrower's disability, accident or illness, and unemployment. Credit life insurance has historically been among the most common bank insurance products.

Credit score. A number that is based on an analysis of an individual's credit history and that insurers may consider as an indicator of risk for purposes of underwriting insurance. Where not prohibited by state law, insurers may consider a person's credit history when underwriting personal lines.

Debt-cancellation contract/debt-suspension agreement. A loan term or contract between a lender and borrower whereby, for a fee, the lender agrees to cancel or suspend payment on the borrower's loan in the event of the borrowers's death, serious injury, unemployment, or other specified events. The Office of the Comptroller of the Currency considers these products to be banking products. State law determines whether these products are bank or insurance products for state-chartered banks and insurance companies.

Deductible. The amount a policyholder agrees to pay toward the total amount of insurance loss. The deductible may apply to each claim for a loss occurrence, such as each automobile accident, or to all claims made during a specified period, as with health insurance.

Directors and officers liability insurance. Liability insurance covering a corporation's obligation to reimburse its directors or officers for claims made against them for alleged wrongful acts. It also provides direct coverage for company directors and officers themselves in instances when corporate indemnification is not available.

Direct premiums written. Premiums received by an underwriter for all policies written during a given time period by the insurer, excluding those received through reinsurance assumed.

Direct writer. An insurance company that deals directly with the insured through a salaried representative, as opposed to those insurers that use agents. This term also refers to insurers that operate through exclusive agents. In reinsurance, a direct writer is the company that originally underwrites the insurance policies ceded.

Disability income insurance. An insurance product that provides income payment to the insured when his or her income is interrupted or terminated because of illness or accident.

Endowment insurance. A type of life insurance contract under which the insured receives the face value of the policy if he or she survives the endowment period. Otherwise, the beneficiary receives the face value of the policy upon the death of the insured.

Errors and omissions (E&O) liability insurance. Professional liability insurance that covers negligent acts or omissions resulting in loss. Insurance agents are continually exposed to the claim that inadequate or inappropriate coverage was recommended, resulting in a lack of coverage for losses incurred. The agent or the carrier may be responsible for coverage for legitimate claims.

Excess-of-loss reinsurance. A form of reinsurance whereby an insurer pays the amount of each claim for each risk up to a limit determined in advance, and the reinsurer pays the amount of the claim above that limit up to a specific sum. It includes various types of reinsurance, such as catastrophe reinsurance, per-risk reinsurance, per-occurrence reinsurance, and aggregate excess-of-loss reinsurance.

Excess-per-risk reinsurance. A form of excess-of-loss reinsurance that, subject to a specified limit, indemnifies the ceding company against the amount of loss in excess of a specified retention for each risk involved in each occurrence.

Excess and surplus lines. Property/casualty coverage that is unavailable from insurers licensed by the state (admitted insurers) and must be purchased from a nonadmitted underwriter.

Exposure. The aggregate of all policyholder limits of liability arising from policies written.

Face amount. The amount stated on the face of the insurance policy to be paid, depending on the type of coverage, upon death or maturity. It does not include dividend additions or additional amounts payable under accidental death or other special provisions.

Facultative reinsurance. Reinsurance of individual risks by offer and acceptance wherein the reinsurer retains the faculty to accept or reject each risk offered by the ceding company.

Facultative treaty. A reinsurance contract under which the ceding company has the option to cede and the reinsurer has the option to accept or decline classified risks of a specific business line. The contract merely reflects how individual facultative reinsurance shall be handled.

Financial guarantee insurance. Financial guarantee insurance is provided for a wide array of financial risks. Typically, coverage is provided for the fulfillment of a specific financial obligation originated in a business transaction. The insurer, in effect, is lending the debtor its own credit rating to enhance the debtor's creditworthiness.

Financial strength rating. Opinion as to an insurance company's ability to meet its senior policyholder obligations and claims. For many years, the principal rating agency for property and casualty insurers and life insurers has been A.M. Best. Other rating agencies, such as Fitch, Moody's, Standard and Poor's, and Weiss, also rate insurers.

Fixed annuity. See *Annuity.*

Flood insurance. A special insurance policy to protect against the risk of loss or damage to property caused by flooding. Regular homeowners' policies do not pay for damages caused by flooding.

General liability insurance. A broad commercial policy that covers all business liability exposures, such as product liability, completed operations, premises and operations, independent contractors, and other exposures that are not specifically excluded.

Gross premiums written. Total premiums for insurance written during a given period, before deduction for reinsurance ceded.

Group insurance. Insurance coverage typically issued to an employer under a master policy for the benefit of employees. The insurer usually does not condition coverage of the people that make up the group upon satisfactory medical examinations or other requirements. The individual members of the group hold certificates as evidence of their insurance.

Health insurance. An insurance product that provides benefits for medical expenses incurred as a result of sickness or accident, as well as income payments to replace lost income when the insured is unable to work because of illness, accident, or disability. This product may be in the form of traditional indemnity insurance or managed-care plans and may be underwritten on an individual or group basis.

Incurred but not reported (IBNR). The loss-reserve value established by insurance and reinsurance companies in recognition of their liability for future payments on losses that have occurred but have not yet been reported to them. This definition is often erroneously expanded to include adverse loss development on reported claims. The term *incurred but not enough reported (IBNER)* is being increasingly used to reflect more accurately the adverse development on inadequately reserved reported claims.

Inland marine insurance. A broad field of insurance that covers cargo being shipped by air, truck, or rail. It includes coverage for most property involved in transporting cargo as well as for bridges, tunnels, and communications systems.

Key person life insurance. Life insurance designed to cover the key employees of an employer. It may be written on a group- or an individual-policy basis.

Lapse. The termination or discontinuance of a policy resulting from the insured's failure to pay the premium due.

Liability insurance. Protects policyholders from financial loss due to liability resulting from injuries to other persons or damage to their property.

Lines. A term used in insurance to denote insurance business lines, as in "commercial lines" and "personal lines."

Long-term care insurance. Health insurance designed to supplement the cost of nursing home care or other care facilities in the event of a long-term illness or permanent disability or incapacity.

Managing general agent. A managing general agent (MGA) is a wholesaler of insurance products and services to insurance agents. An MGA receives contractual authority from an insurer to assume many of the insurance company's functions. The MGA may provide insurance products to the public through local insurance agents as well as provide services to an insurance company, including marketing, accounting, data processing, policy maintenance, and claims-monitoring and -processing services. Many insurance companies prefer the MGA distribution and management system for their insurance products because it avoids the high cost of establishing branch offices. Most states require that an MGA be licensed.

Manuscript policy. A policy written to include specific coverage or conditions not provided in a standard policy.

Morbidity. The incidence and severity of illness and disease in a defined class of insured persons.

Mortality. The rate at which members of a group die in a specified period of time or die from a specific illness.

Mortgage guarantee insurance. A product that insures lenders against nonpayment by borrowers. The policies are issued for a specified time period. Lenders who finance more than 80 percent of the property's fair value generally require such insurance.

Mortgage insurance. Life insurance that pays the balance of a mortgage even if the borrower dies. Coverage typically is in the form of term life insurance, with the coverage declining as the debt is paid off.

Multiperil insurance. An insurance contract providing coverage against many perils, usually combining liability and physical damage coverage.

Net premiums written. The amount of gross premiums written, after deduction for premiums ceded to reinsurers.

Ninety-day loss rule. A state requirement for an insurer to establish a loss provision for reinsurance recoverables over 90 days past due.

Obligatory treaty. A reinsurance contract under which business must be ceded in accordance with contract terms and must be accepted by the reinsurer.

Policyholder. The person or entity who owns an insurance policy. This is usually the insured person, but it may also be a relative of the insured, a partnership, or a corporation.

Premium. The payment, or one of the periodic payments, a policyholder agrees to make for insurance coverage.

Private mortgage insurance (PMI). Coverage for a mortgage lender against losses due to a collateral shortfall on a defaulted residential real estate loan. Most banks require borrowers to take out a PMI policy if a downpayment of less than 20 percent of a home's value is made at the time the loan is originated. PMI does not directly benefit a borrower, although its existence provides the opportunity to purchase a home to many people who otherwise would not qualify for a loan.

Producer. A person licensed to sell, solicit, or negotiate insurance.

Professional designations and organizations. Three of the most common insurance professional designations are chartered life underwriter (CLU), chartered property casualty underwriter (CPCU), and chartered financial consultant (ChFC). Insurance agents also join professional organizations such as the American Society of Chartered Life Underwriters, the International Association of Financial Planning, the National Association of Life Underwriters, the National Association of Health Underwriters, the American Council of Life Insurance, the Life Insurance Marketing and Research Association, the Life Underwriter Training Council, and the Million Dollar Round Table.

Pro rata reinsurance. A generic term describing all forms of "quota-share" and "surplus reinsurance," in which the reinsurer shares a pro rata portion of the losses and premiums of the ceding company.

Property insurance. Coverage for physical damage or destruction of real property (buildings, fixtures, and permanently attached equipment) and personal property (movable items that are not attached to land) that occurs during the policy period as a result of, for example, fire, windstorm, explosion, or vandalism.

Protected cell. A structure available to captive insurers underwriting risks of unaffiliated companies whereby the assets associated with the self-insurance program of one organization are segregated to provide legal-recourse protection from creditors of protected cells providing insurance coverage to other organizations.

Quota-share reinsurance. A form of pro rata reinsurance indemnifying the ceding company for a fixed percent of loss on each risk covered in the contract in consideration of the same percentage of the premium paid to the ceding company.

Rebating. Directly or indirectly giving or offering to give any portion of the premium or any other consideration to an insurance buyer as an inducement to purchase or renew the insurance. Rebates are forbidden under most state insurance codes.

Reinsurance. Insurance placed by an underwriter (the ceding company or reinsured) in another company to transfer or reduce the amount of the risk assumed under the original insurance policy (or group of policies).

Reinsurance premium. The consideration paid by a ceding company to a reinsurer for the coverage provided by the reinsurer.

Residual market. Also known as the shared market, it covers applications for insurance that were rejected by underwriters in the voluntary market that is covered by agency direct-marketing systems, perhaps because of high loss experience by the insured party. The residual market includes government insurance programs, specialty pools, and shared market mechanisms such as assigned-risk plans.

Retrocession. A reinsurance transaction whereby a reinsurer (the retrocedant) cedes all or part of the reinsurance risks it has assumed to another reinsurer (the retrocessionaire).

Retrospective rating. An insurance plan in which the current year's premium is based on the insured's own loss experience for that same period, subject to a maximum and minimum.

Rider. A written attachment, also known as an endorsement, to an insurance policy that changes the original policy to meet specific requirements, such as increasing or decreasing benefits or providing coverage for specific property items beyond that provided for under the insurance company's standard contract terms.

Self-insured retention (SIR). The percentage of a risk or potential loss assumed by an insured, whether in the form of a deductible, self-insurance, or no insurance at all.

Separate accounts. Certain life insurance assets and related liabilities that are segregated and maintained to meet specific investment objectives of contract holders, particularly those assets and liabilities associated with pension plans and variable products offered by life insurers, wherein the customer and not the insurer retains most of the investment and interest-rate risk.

Split-dollar life insurance. An arrangement that typically involves an agreement between an employer and an employee whereby the premium payment, cash values, policy ownership, and death benefits may be split. There are many variations of split-dollar arrangements, including arrangements in which a trust is created to facilitate estate planning. Split-dollar life insurance is designed to serve as a supplemental benefit to a particular company executive. The arrangement typically involves the payment of the insurance premium by the employer, with the death benefit accruing to the employee.

Subrogation. An insurance carrier may reserve the "right of subrogation" in the event of a loss. This means that the company may choose to take action to recover the amount of a claim paid to a covered insured if a third party caused the loss. After expenses, the amount recovered must be divided proportionately with the insured to cover any deductible for which the insured was responsible.

Term life insurance. An insurance product that provides, for a specified period of time, death coverage only. Typically, it has no savings component and, therefore, no cash value. Because term insurance provides only mortality protection, it generally provides the most coverage per premium dollar. Most term life insurance policies are renewable for one or more time periods up to a stipulated maximum age; however, premiums generally increase with the age of the policyholder.

Title insurance. Insurance that protects banks and mortgagees against unknown encumbrances against real estate by indemnifying the mortgagor and property owner in the event that clear ownership of the property is clouded by the discovery of faults in the title. Title insurance policies may be issued to either the mortgagor or the mortgagee or both. Title insurance is written largely only by companies specializing in this class of insurance.

Treaty reinsurance. A reinsurance contract under which the reinsured company agrees to cede, and the reinsurer agrees to assume, risks of a particular class or classes of business.

Twisting. In insurance, twisting involves making misrepresentations to a policyholder to induce the policyholder to terminate one policy and take out another policy with another company, when it is not to the insured's benefit. Twisting is a violation of the Unfair Trade Practices Act. Twisting is similar to the "churning" concept in securities sales, and it results in increased commissions for the inducing agent.

Umbrella liability insurance. This type of liability insurance provides excess liability protection over the "underlying" liability insurance coverage to supplement underlying policies that have been reduced or exhausted by loss.

Underwriting. The process by which a company determines whether it can accept an application for insurance and by which it may charge an appropriate premium for those applications selected. For example, the underwriting process for life insurance classifies applicants by identifying such characteristics as age, sex, health, and occupation.

Unearned reinsurance premium. The part of the reinsurance premium that is applicable to the unexpired portion of the policies reinsured.

Universal life insurance. A form of permanent insurance designed to provide flexibility in premium payments and death benefit protection. The policyholder can pay maximum premiums and maintain a high cash surrender value. Alternatively, the policyholder can make minimal payments in an amount only large enough to cover mortality and other expense charges.

Variable annuity. See *Annuity.*

Variable life insurance. A form of whole life, or universal life, insurance in which the policyholder's cash value is invested in "separate accounts" of the insurer. These accounts are segregated from the insurance carrier's other asset holdings. Such separate account investments are generally not available to a carrier's general creditors in the event of the carrier's insolvency. The policyholder assumes the investment and price risk. Because variable life policies have investment features, life insurance agents selling these policies must be registered representatives of a broker-dealer licensed by the Financial Industry Regulatory Authority and registered with the Securities and Exchange Commission.

Vendors' single-interest insurance. A form of force-placed insurance that is typically purchased by the bank to protect against loss or damage to loan collateral in which the bank has a security interest. The bank passes its expense for this insurance on to the consumer who has either refused or is unable to obtain property insurance.

Viatical settlement. The cashing in of a life insurance policy at a discount from face amount by policyholders who are often terminally ill and need the money for medical care. The purchaser becomes the policyholder as well as the beneficiary and assumes the premium payments of the policy.

Whole life insurance. A fixed-rate insurance product, with premiums and death benefits guaranteed over the duration of the policy. There is a cash value (essentially a savings account) that accrues to the policyholder tax deferred. A policyholder receives the cash value in lieu of death benefits if the policy matures or lapses before the insured's death. A policyholder also may borrow against the policy's accumulated cash value or use it to pay future premiums. For most whole life insurance policies, premiums are constant for the life of the insured's contract.

Insurance Sales Activities and Consumer Protection in Sales of Insurance

Examination Objectives

Effective date November 2003

Section 4043.2

1. To understand the volume and complexity of the state member bank's insurance or annuity program and insurance sales strategy.
2. To assess the financial results of the insurance and annuity sales activity compared with planned results.
3. To determine if the state member bank's insurance and annuity sales activities are effectively integrated into the risk-management, audit, and compliance functions and if the control environment is adequate.
4. To assess the adequacy of the state member bank's controls to ensure compliance with the applicable state and federal laws and regulations.
5. To assess the state member bank's level and direction of operational, legal, and reputational risks from the insurance or annuity sales activity.

The following objectives apply if insurance products or annuities are sold by a bank or another person at an office of, or on behalf of, the bank.

6. To assess the adequacy of the state member bank's oversight program for ensuring compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation. (See section 4043.1.)
7. To assess the effectiveness of the state member bank's audit and compliance programs for the CPSI regulation.
8. To assess the state member bank's current compliance with the CPSI regulation.
9. To obtain commitments for corrective action when the state member bank is in violation of the CPSI regulation or when applicable policies, procedures, practices, or management oversight to protect against violations is deficient.

Insurance Sales Activities and Consumer Protection in Sales of Insurance

Examination Procedures

Effective date November 2003

Section 4043.3

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

The examiner should consider the following procedures, as appropriate, when conducting a risk assessment to determine the level and direction of risk exposure to the state member bank that is attributable to insurance or annuity sales activity. If there are specific areas of concern, the examiner should focus primarily on those areas.

1. *Scope of activities and strategies.* Assess the significance and complexity of the insurance or annuity sales program.
   a. Obtain a general overview of the scope of the state member bank's insurance or annuity sales activities and any anticipated or recent change in or expansion of such activities.
   b. Determine the state member bank's strategy for insurance or annuity sales, including strategies for cross-selling and referrals of insurance and banking products. Determine the institution's experience with any cross-marketing programs for both insurance business generated by the bank and bank business generated by insurance producers.
   c. Obtain two years' worth of income statements, balance sheets, and budget documents for the agency's activities. Compare the expected budget items with their actual results.
   d. Determine the volume and type of insurance or annuity products and services sold or solicited.
   e. Determine what other related services the state member bank provides in connection with its insurance or annuity sales activities, such as providing risk-management services to clients seeking advice on appropriate insurance coverages, claims processing, and other activities.
2. *Insurance sales products and concentrations.*
   a. Determine the composition of sales—
      - by line of business, such as property/casualty insurance, life insurance including annuities, and health insurance;
      - by the proportion of sales to commercial and retail customers; and
      - by the portion of sales that is credit related, such as credit life and credit health insurance.
   b. Determine any sales concentrations to particular entities, industries, or bank customers.
   c. Note any concentrations to large commercial accounts.
   d. Determine what insurance services are provided to the bank, its employees, and bank affiliates.
3. *Legal-entity and risk-management structure for insurance or annuity sales.*
   a. Obtain an organizational chart for the legal-entity and risk-management structure for the insurance or annuity sales activities.
   b. Determine—
      - whether the insurance or annuity sales activity is conducted in an affiliated producer, by the bank itself, through another distribution arrangement, or by a combination of these arrangements;
      - the names of any affiliated insurance agencies and the states where the affiliated insurance agencies are licensed;
      - the locations outside of the United States where insurance or annuities are sold or solicited; and
      - if any subsidiary agency operates as a financial subsidiary under the Gramm-Leach-Bliley Act.
   c. Determine if the insurance or annuity producer is acting as a managing general agent (MGA).[1] If so, determine—
      - the scope of the MGA activities;
      - the state member bank management's assessment of the risk associated with the MGA activity; and

1. MGAs do not assume underwriting risk. Through contractual arrangements with an insurer, MGAs have the authority to write policies on behalf of the insurer in certain instances, thereby binding the insurer to the policy. Certain minimum provisions governing MGA agreements are delineated in the applicable National Association of Insurance Commissioners (NAIC) model law.

- what risk controls are in place to protect the state member bank from potential loss that may arise from the MGA's activities, such as loss arising from legal liability.

4. *Strategic and financial plans.* Assess management controls over the insurance and annuity sales activities.
   a. Ascertain the state member bank management's strategic and financial plans and goals for the insurance or annuity sales activity.
   b. Review the state member bank's due-diligence process for acquiring and pricing agencies, if applicable.
   c. Review the state member bank's financial budgets and forecasts for the activity, particularly plans for new products, marketing strategies and marketing arrangements, and the rate of actual and expected growth for the activity.
   d. Determine the cause for significant deviations from the plan.
   e. Determine if any agency acquired by the state member bank is providing the expected return on investment and if the agency's revenues are covering the debt servicing associated with the purchase, if applicable.
5. *Review of board and committee records and reports.*
   a. Review the reports of any significant state member bank oversight committees, including relevant board of directors and board committee minutes and risk-management reports.
   b. Determine if the board of directors, a board committee, or senior management of the state member bank reviews reports pertaining to consumer complaints and complaint resolution, information pertaining to litigation and associated losses, and performance compared with the organization's plan for the insurance and annuity sales activities.
6. *Policies and procedures.*
   a. Determine—
      - the adequacy of the state member bank's policies and procedures for conducting and monitoring insurance or annuity sales activities, including those policies designed to ensure adherence with federal and state laws and regulations pertaining to consumer protection;
      - whether there are appropriate policies and procedures for the handling of customer funds collected on behalf of the underwriter; accurate and timely financial reporting; complaint monitoring and resolution; effective system security and disaster-recovery plans; and policy-exception tracking and reporting; and
      - if the board of directors or its designated committee has formally approved the policies.
   b. Obtain a detailed balance sheet for agency subsidiaries, and determine if the assets held by insurance or annuity agency subsidiaries of the state member bank are all bank-eligible investments.
   c. Determine the independence of the state member bank's audit program applicable to the insurance and annuity sales activity. Determine if the audit program's scope, frequency, and resources are commensurate with the insurance or annuity sales activities conducted.
   d. Determine how the state member bank selects insurance underwriters with whom to do business, as well as how the state member bank monitors the continuing performance of the underwriters.
   e. Determine the adequacy of the oversight of the bank's board of directors over the insurance management team's qualifications, the training and licensing of personnel, and general compliance with state insurance regulations.
   f. Review the internal controls of the state member bank related to third-party arrangements, including arrangements for sales, processing, and auditing of insurance or annuity sales activities.
7. *Claims, litigation, and functional regulatory supervision.* Assess legal and reputational risk.
   a. Identify any significant litigation against the state member bank arising from its insurance or annuity sales activity and the likely impact of the litigation on the state member bank.
   b. Obtain the insurance agency's errors and omissions claims records for the past several years, including a listing of claims it has made and the amount of claims, the claim status, and the amount of claim payments.
   c. Review the state member bank's policies

and procedures for tracking and resolving claims. Determine if they appear adequate and if they are adhered to.

d. Determine if the applicable functional regulator has any outstanding supervisory issues with the insurance agency.

8. *Consumer complaints.*
   a. Determine if bank managagement has policies and procedures in place to assess whether consumer complaints received are likely to expose the state member bank to regulatory action, litigation, reputational damage, or other significant risk.
   b. Obtain applicable consumer complaint files, and evaluate internal control procedures to ensure the complaints are being adequately addressed.
9. *Audit and compliance functions.*
   a. Determine the date of the most recent review of the insurance or annuity sales activities by the audit and compliance functions.
   b. Determine the adequacy of the state member bank's management policies and procedures for ensuring that any deficiencies noted in such reviews are corrected, and ascertain whether any such deficiencies are being adequately addressed.[2]
10. *Insurance underwriter oversight of agent/agency activities.*
    a. Determine if there are adequate policies and procedures to review and resolve any issues or concerns raised by an insurance underwriter regarding the producers used by, or affiliated with, the state member bank.[3]
    b. Determine whether any of the insurance underwriters conducted a periodic review of the producers that they engaged to sell insurance.
11. *State supervisory insurance authorities.*
    a. During discussions with state member bank management, determine whether state insurance regulators have raised any issues or concerns in correspondence or reports.
    b. Consult with the state insurance regulators, as appropriate, to determine any significant supervisory issues, actions, or investigations. (For multistate agencies, contacts with states may be prioritized on the basis of the location of the agency's head office or by a determination of the significance of sales by state. Both financial examinations and market conduct examinations conducted by the state insurance departments are targeted at insurance underwriters, not agencies. Therefore, information available from the states pertaining to agencies may be very limited.)
12. *Operational risk assessment.* Ascertain from the state member bank's management whether there are—
    a. any significant operational problems or concerns relating to insurance or annuity sales activities;
    b. policies and procedures in place to ensure accurate and timely reporting to the state member bank's management of insurance or annuity sales activity plans, financial results, and significant consumer complaints or lawsuits or compliance issues, such as errors and omissions claims;[4]
    c. appropriate policies and procedures at the state member bank to ensure accurate reporting of insurance or annuity sales activity on Federal Reserve regulatory reports (Determine from applicable Board or Reserve Bank contacts if there are any outstanding issues with respect to potential reporting errors on submitted Federal Reserve reports, bank call reports, or other applicable reports. If so, seek resolution of the issues.); and
    d. adequate disaster-recovery plans and procedures to protect the state member bank from loss of data related to insurance or annuity sales activities.

2. Enforcement of the privacy provisions of the Gramm-Leach-Bliley Act as they relate to state member banks is the responsibility of the Board's Division of Consumer and Community Affairs. However, enforcement of the privacy provisions of the GLB Act with respect to the insurance activities of nondepository subsidiaries of a state member bank is the responsibility of the state insurance regulators.

3. Insurance underwriters generally have procedures to determine whether individual producers affiliated with agencies are selling the underwriters' products in conformance with applicable laws and regulations. The findings and conclusions of these reviews should be available to the state member bank's management.

4. Errors and omissions insurance should be in place to protect the state member bank against loss sustained because of an error or oversight, such as failure to issue an insurance policy. A tracking system to monitor errors and omission claims should be in place and monitored by the state member bank, as appropriate. See section 4040.1, "Management of Insurable Risks."

CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

The following procedures should be risk-focused in accordance with the Federal Reserve's risk-focused framework for supervising banking organizations. The procedures should be carried out as necessary to adequately assess the state member bank's compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation.

1. Determine the role of the state member bank's board of directors and management in ensuring compliance with the CPSI regulation and applicable state consumer regulations.
2. Evaluate the management information system (MIS) reports the state member bank's board or designated committee rely on to monitor compliance with the consumer regulations and to track complaints and complaint resolution.
3. Review the state member bank's policies and procedures to ensure they are consistent with the CPSI regulation, and conduct transaction testing, as necessary, in the following areas.[5]
   a. disclosures, advertising, and promotional materials
   b. consumer acknowledgments
   c. physical separation from areas of deposit-taking activities
   d. qualifications and licensing for insurance personnel
   e. compliance programs and internal audits
   f. hiring, training, and supervision of insurance or annuity sales personnel employed directly by the bank, or of third parties selling insurance or annuity products at a state member bank office or on behalf of the state member bank
   g. compensation practices and training for personnel making referrals
4. If a third party sells insurance or annuities at the state member bank's offices, or on behalf of the bank, review the state member bank's policies and procedures for ensuring that the third party complies with the CPSI regulation and other relevant policies and procedures of the bank.
5. Review the bank's process for identifying and resolving consumer complaints related to the sale of insurance products and annuities.
6. Obtain and review the record of consumer complaints related to the CPSI regulation. (These records are available from the Board's Division of Consumer and Community Affairs database. See CP letter 2001-11.)
7. Include examination findings, as appropriate, in the commercial bank examination report or in other communications to the bank, as appropriate, that pertain to safety-and-soundness reviews of the bank.

5. If the examiner determines that transaction testing of a functionally regulated nonbank affiliate of the state member bank is appropriate in order to determine the state member bank's compliance with the CPSI regulation, the examiner should first consult with and obtain approval from appropriate staff of the Board's Division of Banking Supervision and Regulation.

RISK ASSESSMENT OF INSURANCE AND ANNUITY SALES ACTIVITIES

Program Management

1. Does the state member bank have a comprehensive program to ensure that its insurance and annuity sales activities are conducted in a safe and sound manner?
2. Does the state member bank have appropriate written policies and procedures commensurate with the volume and complexity of the insurance or annuity sales activities?
3. Has bank management obtained the approval of the bank's board of directors for the program scope and the associated policies and procedures?
4. Have reasonable precautions been taken to ensure that disclosures to customers for insurance or annuity sales and solicitations are complete and accurate, and are in compliance with applicable laws and regulations?
5. Does the state member bank effectively oversee the insurance or annuity sales activities, including those involving third parties?
6. Does the state member bank have an effective independent internal audit and compliance program in place to monitor retail sales of insurance or annuity products?
7. Does the bank appropriately train and supervise employees conducting insurance or annuity sales activities?

Management Information Systems

8. Does the state member bank's insurance program management plan establish the appropriate management information systems (MIS) necessary for the board of directors to properly oversee the bank's insurance or annuity sales activities?
9. Does MIS provide sufficient information to allow for the evaluation and measurement of the effect of actions taken to identify, track, and resolve any issues relative to compliance with the Consumer Protection in Sales of Insurance (CPSI) regulation?
10. Does MIS include sales volumes and trends, profitability, policy exceptions and associated controls, customer complaints, and other information providing evidence of compliance with laws and established policies?

Compliance Programs and Internal Audits

11. Are there policies and procedures in place to ensure that insurance or annuity sales activities are conducted in compliance with applicable laws and regulations?
12. Do compliance procedures identify potential conflicts of interest and how such conflicts should be addressed?
13. Do the compliance procedures provide a system to monitor customer complaints and track their resolution?
14. When applicable, do compliance procedures call for verification that third-party sales are being conducted in a manner consistent with the agreement governing the third party's arrangement with the state member bank?
15. Is the compliance function conducted independently of the insurance or annuity sales and management activities?
16. Do compliance personnel determine the scope and frequency of the insurance-product review?
17. Are findings of insurance or annuity sales activity compliance reviews periodically reported directly to the state member bank's board of directors or a designated committee thereof?

CONSUMER PROTECTION IN SALES OF INSURANCE REGULATION

If applicable, review the state member bank's internal controls, policies, practices, and procedures for retail insurance or annuity sales activities conducted by the bank on bank premises or on behalf of the bank. The bank's program management for such activities should be well documented and should include appropriate personnel training, as well as compliance and audit-function coverage of all efforts to ensure compliance with the provisions of the Board's CPSI regulation.

Advertising and Promotional Materials

1. Do advertising materials associated with the insurance or annuity sales program create an erroneous belief that—
   a. an insurance product or annuity sold or offered for sale by the state member bank, or on behalf of the bank, is backed by the federal government or the bank, or that the product is insured by the FDIC?
   b. an insurance product or annuity that involves investment risk does not, in fact, have investment risk, including the potential that principal may be lost and the product may decline in value?
2. Does a review of advertising for insurance products or annuities sold or offered for sale create an erroneous impression that—
   a. the state member bank or an affiliate or subsidiary may condition the grant of an extension of credit to a consumer on the purchase of an insurance product or annuity by the consumer from the bank or an affiliate or subsidiary of the bank?
   b. the consumer is not free to purchase an insurance product or annuity from another source?

Disclosures

3. In connection with the initial purchase of an insurance product or annuity by a consumer, does the initial disclosure to the consumer, except to the extent the disclosure would not be accurate, state that—
   a. the insurance product or annuity is not a deposit or other obligation of, or is not guaranteed by, the state member bank or an affiliate of the bank?
   b. the insurance product or annuity is not insured by the FDIC or any other agency of the United States, the state member bank, or (if applicable) an affiliate of the bank?
   c. in the case of an insurance product or annuity that involves an investment risk, there is risk associated with the product, including the possible loss of value?
4. In the case of an application for credit, in connection with which an insurance product or annuity is solicited, offered, or sold, is a disclosure made that the state member bank may not condition an extension of credit on either—
   a. the consumer's purchase of an insurance product or annuity from the bank or any of its affiliates?
   b. the consumer's agreement not to obtain, or a prohibition on the consumer's obtaining, an insurance product or annuity from an unaffiliated entity?
5. Are the disclosures under question 3 above provided orally and in writing before the completion of the initial face-to-face sale of an insurance product or annuity to a consumer?
6. Are the disclosures under question 4 above made orally and in writing at the time the consumer applies in a face-to-face interaction for an extension of credit in connection with which insurance is solicited, offered, or sold?
7. If a sale of an insurance product or annuity is conducted by telephone, are the disclosures under question 3 above provided in writing, by mail, within three business days?
8. If an application for credit is by telephone, are the disclosures under question 4 above provided by mail to the consumer within three business days?
9. Are the disclosures under questions 3 and 4 above provided through electronic media, instead of on paper, only if the consumer affirmatively consents to receiving the disclosures electronically, and only if the disclosures are provided in a format that the consumer may retain or obtain later?
10. Are disclosures made through electronic media, for which paper or oral disclosures are not required, presented in a meaningful form and format?
11. Are disclosures conspicuous, simple, direct, readily understandable, and designed to call attention to the nature and significance of the information provided?
12. Are required disclosures presented in a meaningful form and format?

Consumer Acknowledgment

13. At the time a consumer receives the required disclosures, or at the time of the consumer's initial purchase of an insurance product or annuity, is a written acknowledgment from the consumer that affirms receipt of the disclosures obtained?
14. If the required disclosures are provided in connection with a transaction that is conducted by telephone—
    a. has an oral acknowledgment of receipt of the disclosures been obtained, and is sufficient documentation maintained to show that the acknowledgment was given?
    b. have reasonable efforts to obtain a written acknowledgment from the consumer been made?

Physical Separation from Deposit Activities

15. Does the state member bank, to the extent practicable—
    a. keep the area where the bank conducts transactions involving the retail sale of insurance products or annuities physically segregated from the areas where retail deposits are routinely accepted from the general public?
    b. identify the areas where insurance product or annuity sales activities occur?
    c. clearly delineate and distinguish insurance and annuity sales areas from the areas where the bank's retail deposit-taking activities occur?

Qualifications and Licensing

16. Does the state member bank permit any person to sell, or offer for sale, any insurance product or annuity in any part of its office, or on its behalf, only if the person is at all times appropriately qualified and licensed under applicable state insurance licensing standards for the specific products being sold or recommended?

Hiring, Training, and Supervision

17. Have background investigations of prospective employees that will sell insurance products or annuities been completed?
18. When a candidate for employment has previous insurance experience, has a review to determine whether the individual has been the subject of any disciplinary actions by state insurance regulators been completed?
19. Do all insurance or annuity sales personnel, or third-party sales personnel conducting sales activities at or on behalf of the state member bank, receive appropriate training and continue to meet licensing requirements?
20. Does training address policies and procedures for sales of insurance and annuity products, and does it cover personnel making referrals to a licensed insurance producer?
21. Does training ensure that personnel making referrals about insurance products or annuities are properly handling all inquiries so as not to be deemed to be acting as unlicensed insurance agents or registered (or equivalently trained) securities sales representatives (for insurance products that are also securities) if they are not qualified?
22. When insurance products or annuities are sold by the state member bank or third parties at an office of, or on behalf of, the organization, does the institution have policies and procedures to designate, by title or name, the individuals responsible for supervising insurance sales activities, as well as the referral activities of bank employees not authorized to sell these products?
23. Does the bank designate supervisory personnel responsible for monitoring compliance with any third-party agreement, as well as with the CPSI regulation?

Referrals

24. Are fees paid to nonlicensed personnel who are making referrals to qualified insurance or annuity salespersons limited to a one-time, nominal fee of a fixed dollar amount for each referral, and is the fee unrelated to whether the referral results in a sales transaction?

Third-Party Agreements

25. Does the state member bank's management conduct a comprehensive review of a third party before entering into any arrangement to conduct insurance or annuity sales activities through the third party?
26. Does the review include an assessment of the third party's financial condition, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with applicable consumer protection laws and regulation?
27. Does the board of directors or a designated committee thereof approve any agreement with the third party?
28. Does the agreement outline the duties and responsibilities of each party; describe the third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information; and define the terms for use of the bank's office space, equipment, and personnel?
29. Does the third-party agreement specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the CPSI regulation, if applicable?
30. Does the agreement authorize the bank to monitor a third party's compliance with the agreement, as well as to have access to third-party records considered necessary to evaluate compliance?
31. Does the agreement provide for indemnification of the institution by the third party for any losses caused by the conduct of the third party's employees in connection with its insurance or annuity sales activities?
32. If an arrangement includes dual employees, does the agreement provide for written employment contracts that specify the duties of these employees and their compensation arrangements?
33. If the state member bank contracts with a functionally regulated third party, does the bank obtain, as appropriate, any relevant regulatory reports of examination of the third party?
34. How does the state member bank ensure that a third party selling insurance or annuity products at or on behalf of the bank complies with all applicable regulations, including the CPSI regulation?
35. How does the state member bank ensure that any third party or dual employee selling insurance or annuity products at or on behalf of the bank is appropriately trained to comply with the minimum disclosures and other requirements of the Board's CPSI regulation and applicable state regulations?
36. Does the bank obtain and review copies of third-party training and compliance materials to monitor the third party's performance regarding its disclosure and training obligations?

Consumer Complaints

37. Does the state member bank have policies and procedures for handling customer complaints related to insurance and annuity sales?
38. Does the customer complaint process provide for the recording and tracking of all complaints?
39. Does the state member bank require periodic reviews of complaints by compliance personnel? Is a review by the state member bank's board and senior management required for significant compliance issues that may pose risk to the state member bank?

INTRODUCTION

Banks routinely rely on third parties for a range of products, services, and other activities. The use of third parties can offer banks efficient access to technologies, human capital, delivery channels, products, services, and markets. As a result, the numbers and types of banks' third-party relationships have increased over time. The use of third parties, especially those utilizing new technologies, may present elevated risks to a bank and its customers, including operational, compliance, and strategic risks. Therefore, when a bank uses a third party, the bank needs a strong risk-management process to ensure that the third party conducts its activities in a safe-and-sound manner and in compliance with applicable laws and regulations. Such laws and regulations include those designed to protect consumers (i.e., fair lending laws and prohibitions against unfair, deceptive, or abusive acts or practices) and those addressing financial crimes.

The purpose of this manual section is to provide a summary of *Interagency Guidance on Third-Party Relationships* (interagency guidance) issued by the Federal Reserve, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (collectively, the agencies) on managing risks associated with third-party relationships. For the complete guidance see SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management."[1]

INTERAGENCY GUIDANCE ON MANAGING RISKS ASSOCIATED WITH THIRD-PARTY RELATIONSHIPS

Overview

The agencies issued the interagency guidance to assist banks in identifying and managing risks associated with third-party relationships and in complying with applicable laws and regulations.[2] Furthermore, the interagency guidance offers the agencies' views on sound risk-management principles for supervised institutions when developing and implementing risk-management practices for all stages in the life cycle of third-party relationships. In the end, a bank's third-party risk management should reflect the level of risk, complexity, and size of the bank and the nature of its third-party relationship.

Applicability of the Guidance

The interagency guidance is relevant to institutions supervised by the agencies. For the Federal Reserve, this primarily includes state member banks, bank holding companies, savings and loan holding companies, U.S. branches and agencies of foreign banking organizations, and Edge Act and agreement corporations.

The interagency guidance addresses any business arrangement between a bank and a third-party entity, by contract or otherwise. A "business arrangement" is another term for "third-party relationship," including

- outsourced services,
- independent consultants,
- referral arrangements,
- merchant payment processing services,
- services provided by affiliates and subsidiaries, and
- joint ventures.

Risk Management

As a third-party relationship presents a varying level of risk, a bank's risk-management practices should include

- analyzing the risks associated with each third-party relationship;
- tailoring risk-management practices, commensurate with the bank's size, complexity, and risk profile as well as the nature of the third-party relationship;

1. See also 88 Fed. Reg. 37,920 (June 9, 2023).
2. These include the "Interagency Guidelines Establishing Standards for Safety and Soundness," and the "Interagency Guidelines Establishing Information Security Standards," which were adopted pursuant to the procedures of section 39 of the Federal Deposit Insurance Act and section 505 of the Graham Leach Bliley Act, respectively. See 12 CFR pt. 208, appendices D-1 and D-2.

- maintaining a complete inventory of its third-party relationships;
- periodically conducting risk assessments for each third-party relationship and determining whether risks have changed over time and risk-management practices need to be updated; and
- engaging in more rigorous oversight and management of third-party relationships that support higher-risk activities, including the bank's critical activities.

Critical Activities

Critical activities will depend upon a bank's risk profile and business operations. Characteristics of critical activities may include those activities that could

- cause a bank to face significant risk if the third party fails to meet expectations;
- have significant customer impacts; or
- have a significant impact on a bank's financial condition or operations.

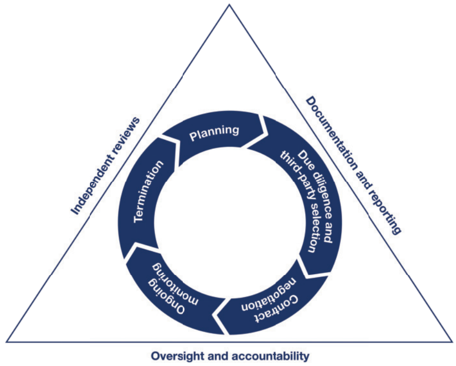
A bank should identify its critical activities and third-party relationships that support these activities. Some banks may assign a criticality or risk level to each third-party relationship, whereas others identify critical activities and those third parties that support such activities.

Third-Party Relationship Life Cycle

Effective third-party risk management generally follows a continuous life cycle for third-party relationships. The stages of the risk-management life cycle of third-party relationships are shown in figure 1 and detailed below. The interagency guidance includes examples of risk-management practices that a bank may find helpful in the development and maintenance of its risk-management process. However, these examples may not apply to all banks' third-party relationships.

Bank staff with the requisite knowledge and skills should appropriately implement each stage of the risk-management life cycle. A bank may involve experts across disciplines, such as compliance, risk, or technology as well as legal counsel, and may engage external support when helpful to supplement the qualifications and technical expertise of in-house staff.[3]

Figure 1. The risk-management life cycle of third-party relationships



Planning

As part of sound risk management, effective planning allows a bank to evaluate and consider its approach for managing risks before entering into a third-party relationship. Certain third parties, such as those that support a bank's higher-risk activities, including critical activities, typically warrant a greater degree of planning and consideration. For example, when critical activities are involved, plans may be presented to and approved by a bank's board of directors (or a designated board committee).

Due Diligence and Third-Party Selection

Conducting due diligence on third parties before selecting and entering into third-party relationships is an important part of sound risk management. Due diligence includes assessing the third party's ability to perform the activity as expected, adhere to a bank's policies related to the activity, comply with all applicable laws and regulations, and conduct the activity in a safe and sound manner. The due diligence process provides

- management with the information needed about potential third parties to determine if a

3. When a bank uses a third-party assessment service or utility, it has a business arrangement with that entity. Therefore, the arrangement should be incorporated into the bank's third-party risk-management processes.

relationship would help achieve a bank's strategic and financial goals; and
- the bank with the information needed to evaluate whether it can appropriately identify, monitor, and control risks associated with the particular third-party relationship.

Relying solely on experience with or prior knowledge of a third party is not an adequate proxy for performing appropriate due diligence, as the scope and degree of due diligence should be commensurate with the level of risk and complexity of the third-party relationship.[4]

Contract Negotiation

When evaluating whether to enter into a relationship with a third party, a bank typically determines whether a written contract is needed, and if the proposed contract can meet its business goals and risk-management needs. After such determination, a bank typically negotiates contract provisions that will facilitate effective risk management and oversight and that specify the expectations and obligations of both the bank and the third party. A bank may tailor the level of detail and comprehensiveness of such contract provisions based on the risk and complexity posed by the particular third-party relationship.

Ongoing Monitoring

Ongoing monitoring enables a bank to (1) confirm the quality and sustainability of a third party's controls and ability to meet contractual obligations; (2) escalate significant issues or concerns, such as material or repeat audit findings, deterioration in financial condition, security breaches, data loss, service interruptions, compliance lapses, or other indicators of increased risk; and (3) respond to such significant issues or concerns when identified.

Typical monitoring activities include:

1. Reviewing reports regarding the third party's performance and the effectiveness;
2. Periodically visiting and meeting with third-party representatives; and
3. Regularly testing a bank's controls that manage risks from its third-party relationships.

Table 1 provides information on a bank's risk management of third-party relationships, focusing on due diligence, contract negotiations, and ongoing monitoring considerations.

Termination

A bank may terminate a relationship for various reasons, such as expiration or breach of the contract; the third party's failure to comply with applicable laws or regulations; or a desire to seek an alternate third party, bring the activity in-house, or discontinue the activity. In terminating a relationship, bank management should consider whether the activities will be transitioned to another third party, brought in-house, or discontinued. Depending on the degree of risk and complexity of the third-party relationship, a bank typically considers various factors to facilitate termination such as

- transitioning services and activities.
- costs and fees associated with termination.
- managing risks associated
  - — with data retention and destruction;
  - — information system connections and access control, or other control concerns;
  - — handling of joint intellectual property; and
  - — with the termination of services including any impact on customers and the necessary action to address the third party's inability to perform in accordance with service expectations.

Governance

Oversight and Accountability

Proper oversight and accountability in the third-party risk-management process aid a bank in minimizing adverse financial, operational, or other consequences. A bank's board of directors has ultimate responsibility for providing oversight for third-party risk management and holding bank management accountable. The board also provides clear guidance regarding acceptable risk appetite, approves appropriate policies, and ensures that appropriate procedures and

4. For more background information, see *Community Bank Access to Innovation Through Partnerships* (September 2021) and *Interagency Due Diligence Guide for Community Banks* (August 2021).

practices have been established. In turn, bank management is responsible for developing and implementing third-party risk-management policies, procedures, and practices, commensurate with the bank's risk appetite and the level of risk and complexity of its third-party relationships. Table 2 highlights the typical roles and responsibilities of a bank's board and management in the third-party risk-management process.

Independent Reviews

Periodic independent reviews of third-party relationships allow a bank to assess the adequacy of its risk-management processes over third-party activities. Such reviews typically consider whether

- the third-party relationships align with the bank's business strategy, and with internal policies, procedures, and standards;
- risks of third-party relationships are identified, measured, monitored, and controlled;
- the bank's processes and controls are designed and operating adequately;
- the bank's staff with appropriate expertise are engaged to perform risk-management activities throughout the third-party risk-management life cycle; and
- conflicts of interest or appearances of conflicts of interest are avoided or eliminated when a bank selects a third party and as part of its oversight process for monitoring the activities of third parties.

The results of independent reviews may aid a bank in determining whether and how to adjust its third-party risk-management process, including its policies, reporting, resources, expertise, and controls. Furthermore, bank management should respond promptly and thoroughly to issues or concerns identified and escalate them to the bank's board of directors, as appropriate.

Documentation and Reporting

Documentation and reporting are key elements of a bank's risk-management process for overseeing third-party risk activities and the activities of specific third-party relationships throughout the life cycle of that relationship. The extent of documentation and reporting will depend on the complexity of a bank's third-party relationships. The following are examples of processes that support effective documentation and internal reporting:

- a current inventory of all third-party relationships (and, as appropriate, related subcontractors) that clearly identifies higher-risk and critical activities;
- planning and risk assessments related to the use of third parties;
- due diligence results and recommendations;
- executed contracts;
- results of independent reviews;
- remediation plans and related reports addressing the quality and sustainability of the third party's controls;
- risk and performance reports required and received from the third party as part of ongoing monitoring;
- if applicable, reports related to customer complaints and inquiry monitoring, and any subsequent remediation reports;
- reports from third parties of service disruptions, security breaches, or other events that pose, or may pose, a material risk to the bank; and
- periodic reporting to the board of directors (including, as applicable, dependency on a single provider for multiple activities).

Supervisory Review of Third-Party Relationships

The Federal Reserve reviews its supervised institutions' risk management of third-party relationships as part of its supervisory processes, tailored to the institution's asset size and complexity. Supervisory reviews will evaluate risks and the effectiveness of risk management to determine whether activities are conducted in a safe-and-sound manner and in compliance with applicable laws and regulations.

In evaluating a bank's third-party risk management, examiners consider whether the bank engages in a diverse set of third-party relationships, recognizing that not all third-party risk relationships present the same risks, and that a bank accordingly tailors its practices to the risks. Thus, the scope of the supervisory review depends on the degree of risk and the complexity associated with a bank's activities and third-party relationships. When reviewing third-party risk-management processes, examiners typically conduct the following activities, among others:

- assess the ability of the bank's management to oversee and manage the bank's third-party relationships;
- assess the impact of third-party relationships on the bank's risk profile and key aspects of financial and operational performance, including compliance with applicable laws and regulations;
- perform transaction testing or review results of testing to evaluate third-party activities and assess compliance with applicable laws and regulations;
- highlight and discuss any material risks and deficiencies in the bank's risk-management process with senior management and the board of directors, as appropriate;
- review the bank's plans for appropriate and sustainable remediation of any deficiencies, particularly those associated with the oversight of third parties that involve critical activities; and
- consider supervisory findings when assigning the components of the applicable rating system and highlight any material risks and deficiencies in the report of examination or supervisory letter.

When circumstances warrant, the Federal Reserve may use its legal authority to examine functions or operations that a third party performs on behalf of a bank. Such examinations may evaluate the third party's ability to fulfill its obligations in a safe-and-sound manner and comply with applicable laws and regulations, including those designed to protect customers and to provide fair access to financial services. The Federal Reserve may pursue corrective measures, including enforcement actions, when necessary to address violations of laws and regulations or unsafe or unsound banking practices by the bank or its third party.

Table 1. Bank risk management of third-party relationships

Risk-management theme	**Due diligence considerations** *The bank should consider the third party's…*	**Contract considerations** *Effective contracts typically discuss…*	**Ongoing monitoring** *The bank should assess…*
Strategies and goals	• Current and proposed strategic business arrangements. • Service philosophies, quality initiatives, and employment policies and practices.	• The nature and scope of the business arrangement. • The activities the third party will perform. • Ancillary services, such as software, technology support, maintenance, and customer service. • Terms governing the use of the bank's information, facilities, personnel, systems, intellectual property, and equipment as well as the bank's or customers' information. • All costs and compensation arrangements.	Changes to the third party's business strategy that may pose new or increased risks or impact the third party's ability to meet contractual obligations.
Legal and regulatory compliance	• Ownership structure. • Whether the third party is subject to sanctions. • Expertise, processes, and controls to enable the bank to comply with applicable laws and regulations. • Responsiveness to issues. • Process to mitigate, areas of potential consumer harm.	The obligations of the third party and the bank to comply with applicable laws and regulations.	The third party's ongoing compliance with applicable laws and regulations and its performance as measured against contractual obligations.
Financial condition	• Audited financial statements, annual reports, and filings with the U.S. Securities and Exchange Commission.	The type and frequency of reports to be received from the third party, including performance reports, financial reports, security reports, and control assessments.	Changes in the third party's financial condition, including its financial obligations to others.
Business experience	• Depth of resources (including staffing). • Previous experience. • History of addressing customer complaints.	The terms governing the use of the bank's personnel. If dual employees will be used, it may also be helpful to specify their responsibilities and reporting lines.	Changes in the third party's key personnel involved in the activity.

Risk-management theme	**Due diligence considerations** *The bank should consider the third party's…*	**Contract considerations** *Effective contracts typically discuss…*	**Ongoing monitoring** *The bank should assess…*
Qualifications and backgrounds of key personnel and other human resources considerations	• Background checks on the third party's key personnel and contractors. • Ability to identify and remove employees failing to meet suitability requirements. • Succession and redundancy planning.	Performance measures that do not incentivize imprudent performance or behavior, such as encouraging processing volume or speed without regard for accuracy, compliance requirements, or adverse effects on the bank or customer.	Training provided to employees of the bank and the third party.
Risk management	• Policies, processes, and internal controls. • Alignment with applicable policies and expectations of the bank surrounding the activity. • Audit assessments, including independent testing and objective reporting of results and findings. • System and Organization Control (SOC) reports.	Provisions for periodic, independent audits of the third party and its relevant subcontractors, consistent with the risk and complexity of the third-party relationship.	Relevant audits, testing results, and other reports that address whether the third party remains capable of managing risks and meeting contractual obligations and regulatory requirements.
Information security	• Information security program and determine whether there are any gaps that present risk. • Experience in identifying, assessing, and mitigating, known and emerging threats and vulnerabilities.	When and how the third party will disclose, in a timely manner, information security breaches or unauthorized intrusions.	The third party's response to changing threats, new vulnerabilities, and incidents impacting the activity, including any resulting adjustments to the third party's operations or controls.
Management information systems	• Ability to identify gaps in service-level expectations, business process and management, and interoperability issues. • Processes for maintaining timely and accurate inventories of its technology and its contractor(s).	• Prohibitions on the use and disclosure of bank and customer information by a third party and its subcontractors, except as necessary to provide the contracted activities or comply with legal requirements. • Obligations for retention and provision of timely, accurate, and comprehensive information.	The third party's ability to maintain the confidentiality, availability, and integrity of the bank's systems, information, and data, as well as customer data, where applicable.

Risk-management theme	**Due diligence considerations** *The bank should consider the third party's…*	**Contract considerations** *Effective contracts typically discuss…*	**Ongoing monitoring** *The bank should assess…*
Operational resilience	• Results from operational resilience and business continuity testing and performance during actual disruptions. • Telecommunications redundancy and resilience plans. • Preparations for threats and vulnerabilities, such as natural disasters, pandemics, distributed denial of service attacks, or other intentional or unintentional events.	The continuation of the activity in the event of problems affecting the third party's operations, including degradations or interruptions in delivery.	The third party's response to incidents, business continuity and resumption plans, and testing results to evaluate the third party's ability to respond to and recover from service disruptions or degradations.
Incident reporting and management processes	Documented processes, timelines, and accountability for identifying, reporting, investigating, and escalating incidents.	Whether the bank or the third party is responsible for responding to customer complaints or inquiries.	The volume, nature, and trends of customer inquiries and complaints, the adequacy of the third party's responses (if responsible for handling customer inquiries or complaints), and any resulting remediation.
Physical security	Physical and environmental controls to protect the safety and security of people, facilities, technology systems, and data, as applicable.	The terms governing the use of the bank's facilities, personnel, systems, and equipment.	*See ongoing monitoring for "Operational resilience" above.*
Reliance on subcontractors	Ability to identify, manage, and mitigate risks associated with subcontracting, including how the third party selects and oversees its subcontractors and ensures that its subcontractors implement effective controls.	When and how the third party should notify the bank of its use or intent to use a subcontractor and whether specific subcontractors are prohibited by the bank.	The third party's reliance on, exposure to, and use of subcontractors, the location of subcontractors (and any related data), and the third party's own risk-management processes for monitoring subcontractors.

Risk-management theme	**Due diligence considerations** *The bank should consider the third party's…*	**Contract considerations** *Effective contracts typically discuss…*	**Ongoing monitoring** *The bank should assess…*
Insurance coverage	Insurance policies and the extent to which potential losses are mitigated, including losses posed by the third party to the bank.	• Specified types and amounts of insurance (including, if appropriate, naming the bank as insured or additional insured). • Notifications to the bank of material changes to coverage. • Expectations for evidence of coverage, as appropriate.	Changes to, or lapses in, the third party's insurance coverage.
Contractual agreements with other parties	Legally binding arrangements with subcontractors or other parties to determine whether such arrangements may create or transfer risks to the bank or its customers.	• Indemnification clauses specifying the extent to which the bank will be held liable for claims or be reimbursed for damages based on the failure of the third party or its subcontractor to perform. • The dispute resolution process to resolve problems between the bank and the third party in an expeditious manner, and whether the third party should continue to provide activities to the bank during the dispute resolution period. • The extent to which the third party has the right to use the bank's information, technology, and intellectual property, such as the bank's name, logo, trademark, and copyrighted material.	Changes to the third party's agreements with other entities that may pose new or increased risks or impact the third party's ability to meet contractual obligations.

Table 2. Third-party risk-management responsibilities for a bank's board of directors and management

Board of directors (or a designated board committee)	Bank management
• Assessing whether third-party relationships are managed in a manner consistent with the bank's strategic goals and risk appetite and in compliance with applicable laws and regulations • Assessing whether there is appropriate periodic reporting on third-party relationships to monitor third-party relationships and these activities • Determining whether management has taken appropriate actions to remedy performance issues and address changing risks or material issues	• Integrating third-party risk management with the bank's overall risk-management processes • Directing the planning, due diligence, and ongoing monitoring of third-party activities • Reporting periodically on third-party activities to the board (or designated board committee) • Providing that contracts with third parties are appropriately reviewed, approved, and executed • Establishing appropriate organizational structures and staffing to oversee third-party activities • Implementing and maintaining an appropriate system of internal controls to manage risks associated with third-party relationships • Assessing whether the bank's compliance management system is appropriate given the nature, size, complexity, and scope of its third-party relationships • Determining whether the bank has appropriate access to data and information from its third parties • Escalating significant issues to the board and monitoring any resulting remediation, including actions taken by the third party • Appropriately terminating business arrangements with third parties

LITIGATION AND OTHER LEGAL MATTERS

Events or conditions arising from litigation,[1] claims, and assessments are matters within the direct knowledge and, often, control of bank management. Accordingly, management is the primary source of information about these matters.[2] Examiners ordinarily do not possess legal skills and therefore cannot make legal judgments on such information.[3] Examiners should request that bank management send a letter of inquiry to those attorneys with whom it has consulted on litigation, claims, and assessments. The letter of inquiry is the examiner's primary means of corroborating information furnished by management.

When requesting these inquiries, examiners should consider the scope of counsel's involvement with the bank. Banks may engage a number of law firms, so examiners should have the bank direct requests to both general counsel and counsel whose service is limited to particular matters. Ordinarily, inquiries should be made of all outside counsel.

In certain instances, however, examiners may be reasonably certain that some of the bank's counsels are handling only routine matters that ultimately will not have a significant effect on the bank's financial condition. In these cases, the examiner-in-charge may decide not to send letters of inquiry to those counsels.

Requests for corroboration from legal counsel should ask for information about litigation, impending litigation, claims, and contingent liabilities. For the purposes of these requests, the terms impending litigation and contingent liabilities have the following meanings:

1. Legal risk arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a financial institution.
2. In limited circumstances, a bank director who is not an officer of the bank may have direct knowledge and control of legal information, usually when the director's primary occupation is as an attorney. Management in these rare instances may have limited knowledge and control of legal information.
3. Appropriate examination staff should notify the enforcement section of Board Legal of any investigations or other legal actions being conducted by governmental regulators or criminal prosecutors against the bank when such information is ascertained during the examination process.

- *Impending litigation.* Litigation threatened against the bank by a third party but not formally commenced.
- *Contingent liabilities.* Matters other than litigation or claims, which available information indicates have at least a reasonable possibility of impairing assets or increasing liabilities. Contingent liabilities should include unasserted claims or assessments.

A letter of inquiry should ask for a response both as of the examination date and as of the date of counsel's response. That date of response should be as close to the completion of the examination as practicable, yet should allow sufficient time for evaluation of responses and follow-up of nonreplies. In some cases, the examiner may wish to obtain an interim response (in addition to a final response) so that a timely preliminary evaluation of material legal matters may be made. Letters of inquiry should be sent early enough to allow them to circulate within the law firm because several attorneys may be considering legal matters for the bank. Before completing the examination, examiners should request that appropriate bank officials contact counsel who have not responded to the initial letter of inquiry.

If examination staff have reason to believe that there may be subsequent developments, the examiner should contact bank management again before submitting the report of examination. If bank management is uncooperative or regarded as incapable of supervising matters concerning litigation, or if other sensitivities mandate circumvention of bank management, then examiners should bring the matter to the attention of Federal Reserve Bank management for further communications with the bank's management and counsel, which could include direct contact with bank counsel.

EXAMINATION-RELATED SUBSEQUENT EVENTS

As a practical matter, the examination, and therefore the report of examination, is as of a stated date. However, events or transactions sometimes occur, subsequent to the date of examination, but before the date the report of examination is submitted to the Reserve Bank, that may have a significant effect on the soundness of a bank. Such events and transactions are referred to as "subsequent events" and may be of two types.

One type includes those events or transactions that provide additional evidence about conditions that existed at the examination date. Examples of this type are the bankruptcy of a significant borrower or the resolution of outstanding litigation.

The second type includes those events that provide evidence about conditions that did not exist at the date of examination but that arose subsequently. An example of that type of event would be new litigation arising subsequent to the examination date but before submission of the examination report.

All information that becomes available before the submission of the report of examination should be used by examiners in the evaluation of the bank. Accordingly, all events or transactions that either significantly affect or have the potential to significantly affect the soundness of the bank should be reflected in the report of examination, regardless of whether they occurred before or subsequent to the examination date.

Litigation and Other Legal Matters, and Examination-Related Subsequent Events

Examination Objectives

Effective date October 2018

Section 4070.2

1. To determine whether any events or transactions have occurred subsequent to the examination date that have had or may have a significant impact on the present or future soundness of the bank or on the conclusions expressed in the report of examination.
2. To determine the adequacy of risk management practices surrounding litigation and other legal matters.
3. To determine the effect of legal counsel's evaluation of litigation, impending litigation, claims, and contingent liabilities on the examiner's overall conclusion regarding the soundness of the bank.

Litigation and Other Legal Matters, and Examination-Related Subsequent Events
Examination Procedures
Effective date October 2018

Section 4070.3

1. Read minutes of all meetings of stockholders, directors, and appropriate committees (investment, loans, etc.).
   a. Ascertain from officials of the bank whether minutes of all such meetings subsequent to the examination date are set forth in the minute book.
   b. As to meetings for which minutes have not been prepared at the date of the review, inquire directly of persons present at the meetings and, preferably, of the person charged with the responsibility of preparing the minutes, concerning matters dealt with at such meetings.
2. If specific violations of law or areas of weakness have been reported to management earlier in the examination, determine the extent to which management has proceeded toward corrective action.
3. Obtain from the bank officer responsible for legal matters a listing of impending or threatened litigation. For each item, the following information should be included:
   a. nature of the litigation
   b. progress of case to date
   c. how management is responding or intends to respond to the litigation
   d. an evaluation of the likelihood of an unfavorable outcome and an estimate, if one can be made, of the amount or range of potential loss
4. Obtain from the bank officer responsible for legal matters a listing of unasserted claims or assessments management considers will probably be asserted and which, if asserted, would have at least a reasonable possibility of an unfavorable outcome. For each item, the following information should be included:
   a. nature of the matter
   b. how management intends to respond if the claim is asserted
   c. possible exposure if the claim is asserted
5. Obtain from management a listing of attorneys and legal firms to whom litigation and related matters have been referred. Also, obtain a listing of any litigation noted in the newest review done by internal or external auditors from the examiner assigned internal control, and determine that corrections have been accomplished.
6. Review bills supporting major charges to the general ledger expenses account(s) for legal services as a test of the completeness of the list supplied by the bank.
7. Request that management incorporate information obtained in above steps in a letter to the bank's legal counsel for corroboration.
8. Evaluate management's listing of litigation, unasserted claims and assessments, and counsel's replies for the effect on the financial condition of the bank, giving appropriate consideration to any insurance coverage.
9. Obtain and review copies of any subsequent interim financial statements. Examples of such statements are—
   a. published reports sent to shareholders or others;
   b. reports submitted to the board of directors by internal auditors, external auditors, or management;
   c. statements of condition; and
   d. income statements.
      - Inquire as to whether interim statements obtained were prepared on the same basis as that used for the statements as of the examination date. If not, request proper adjustments to the interim statements.
      - Compare the interim financial statements, especially income statements, with similar statements for the corresponding period in the prior year and to budgets, profit plans, etc., for the current period, if such are available.
      - Obtain from management satisfactory explanations for any unusual items or significant fluctuations noted.
10. Make inquiries of and hold discussions with officers and other executives who have responsibility for the following matters:
    a. changes in credit lines or transactions with officers, directors, controlling shareholders, affiliated bank holding companies, affiliates of an affiliated holding company, or their interests
    b. changes in significant accounting policies
    c. changes in senior officers
    d. any event or combination of events which

have had or could have a material adverse effect on the bank's financial condition, including liquidity, or results of operation, such as the default of a bond issue in which the bank has substantial holdings or the filing of bankruptcy by a major borrower

e. commencement or discontinuance of services not requiring prior approval
f. execution of significant contracts, such as for employment, leases, pension, or other fringe benefit programs
g. significant new contingent liabilities or commitments other than those referred to above
h. significant changes in assets which may not be evident from the review of subsequent interim financial statements, such as a shift in the amount of loans or investments in special categories, or unusal adjustments made in or after the subsequent interim financial statements reviewed in connection with the previous procedure

11. Distribute information obtained in the previous steps to the appropriate examiners. Notify the enforcement section of Board Legal of any investigations or other legal actions being conducted by governmental regulators or criminal prosecutors against the bank when such information is ascertained during the examination process
12. Make additional inquiries or perform such procedures as considered necessary and appropriate to dispose of questions that arose in the course of the preceding procedures, inquiries, and discussions.
13. If, as a result of performing the above procedures, information is obtained that has a significant impact on the evaluation of the soundness of the bank, extend the appropriate examination procedures so that sufficient evidence is reviewed and documented in the workpapers to support the conclusions reached.
14. Prepare comments for the examination report on any events or transaction noted which may have a material effect on the soundness of the bank.
15. Update the workpapers with any information that will facilitate future examinations.

Internal Control and Audit Function, Oversight, and Outsourcing

Effective date April 2013

Section 4500.1

This section sets forth the principal aspects of effective internal control and audit and discusses some pertinent points relative to the internal control questionnaires (ICQs). It assists the examiner in understanding and evaluating the objectives of and the work performed by internal and external auditors. It also sets forth the general criteria the examiner should consider to determine if the work of internal and external auditors can be relied on in the performance of the examination. To the extent that audit records can be relied on, they should be used to complete the ICQs implemented during the examination. In most cases, only those questions not fully supported by audit records would require the examiner to perform a detailed review of the area in question.

Effective internal control is a foundation for the safe and sound operation of a financial institution. The board of directors and senior managers of an institution are responsible for ensuring that the system of internal control is effective. Their responsibility *cannot* be delegated to others within or outside the organization. An internal audit function is an important element of an effective system of internal control. When properly structured and conducted, internal audit provides directors and senior management with vital information about the condition of the system of internal control, and it identifies weaknesses so that management can take prompt, remedial action. Examiners are to review an institution's internal audit function and recommend improvements if needed. In addition, under the Interagency Guidelines Establishing Standards for Safety and Soundness,[1] pursuant to section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1), each institution is required to have an internal audit function that is appropriate to its size and the nature and scope of its activities.

In summary, internal control is a process designed to provide reasonable assurance that the institution will achieve the following objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations. Internal control consists of five components that are a part of the management process: control environment, risk assessment, control activities, information and communication, and monitoring activities. The effective functioning of these components, which is brought about by an institution's board of directors, management, and other personnel, is essential to achieving the internal control objectives. This description of internal control is consistent with the Committee of Sponsoring Organizations of the Treadway Commission (COSO) report *Internal Control—Integrated Framework.* In addition, under the COSO framework, financial reporting is defined in terms of published financial statements, which, for these purposes, encompass financial statements prepared in accordance with generally accepted accounting principles and regulatory reports (such as the Reports of Condition and Income). Institutions are encouraged to evaluate their internal control against the COSO framework.

This section includes the March 17, 2003, "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing." In addition, that policy statement is immediately followed by a January 23, 2013, "Federal Reserve Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing," which supplements the 2003 guidance.

AUDIT COMMITTEE OVERSIGHT

Internal and external auditors will not feel free to assess the bank's operations if their independence is compromised. This can sometimes happen when internal and external auditors report solely to senior management instead of to the board of directors.

The independence of internal and external auditors is increased when they report to an independent audit committee (one made up of external directors who are not members of the bank's management). The auditors' independence is enhanced when the audit committee takes an active role in approving the internal and external audit scope and plan.

The role of the independent audit committee is important. The audit committee's duties may include (1) overseeing the internal audit function; (2) approving or recommending the appointment of external auditors and the scope

1. For state member banks, see appendix D-1 to 12 CFR 208.

of external audits and other services; (3) providing the opportunity for auditors to meet and discuss findings apart from management; (4) reviewing with management and external auditors the year-end financial statements; and (5) meeting with regulatory authorities.

Public Company Accounting Oversight Board

The Sarbanes-Oxley Act of 2002 (the act) became law on July 30, 2002 (Pub. L. No. 107-204). The act addresses weaknesses in corporate governance and the accounting and auditing professions and includes provisions addressing audits, financial reporting and disclosure, conflicts of interest, and corporate governance at publicly owned companies. The act, among other things, requires public companies to have an audit committee made entirely of independent directors. Publicly owned banking organizations that are listed on the New York Stock Exchange (NYSE) and Nasdaq must also comply with those exchanges' listing requirements, which include audit committee requirements.

The act also established a Public Company Accounting Oversight Board (PCAOB) that has the authority to set and enforce auditing, attestation, quality-control, and ethics (including independence) standards for auditors of public companies (subject to Securities and Exchange Commission (SEC) review). (See SR-02-20.) Accounting firms that conduct audits of public companies (registered accounting firms) must register with the PCAOB and be subject to its supervision. The PCAOB is also empowered to inspect the auditing operations of public accounting firms that audit public companies as well as impose disciplinary and remedial sanctions for violations of its rules, securities laws, and professional auditing and accounting standards. (See www.pcaobus.org.)

Nonpublic banking organizations are encouraged to periodically review their policies and procedures relating to corporate-governance and auditing matters. This review should ensure that such policies and procedures are consistent with applicable law, regulations, and supervisory guidance and remain appropriate in light of the organization's size, operations, and resources. Furthermore, a banking organization's policies and procedures for corporate governance, internal controls, and auditing will be assessed during the supervisory process, and supervisory action may be taken if there are deficiencies or weaknesses in these areas that are inconsistent with sound corporate-governance practices or safety-and-soundness considerations.

DISCIPLINARY ACTIONS AGAINST ACCOUNTANTS AND ACCOUNTING FIRMS PERFORMING CERTAIN AUDIT SERVICES

Section 36 of the Federal Deposit Insurance Act (the FDI Act) authorizes the federal bank and thrift regulatory agencies (the agencies)[2] to take disciplinary actions against independent public accountants and accounting firms that perform audit services covered by the act's provisions. Section 36, as implemented by part 363 of the FDIC's rules (12 CFR 363), requires that each federally insured depository institution with total assets of $500 million or more obtain an audit of its financial statements and a management report. Institutions with assets of $1 billion or more must provide an attestation on management's assertions concerning internal controls over financial reporting that is performed by an independent public accountant (the accountant). The respective insured depository institution must include the accountant's audit and attestation reports in its annual report, as required. See the section on "Legal Requirements Affecting Banks and the Audit Function."

The agencies amended their rules, pursuant to section 36, that set forth the practices and procedures to implement their authority to remove, suspend, or debar, for good cause,[3] an accountant or firm from performing audit and attestation services for insured depository institutions with assets of $500 million or more.[4] Immediate suspensions are permitted in limited circum-

2. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. The Board approved its rules on August 6, 2003 (press release of August 8, 2003). The rules became effective October 1, 2003. They were later revised as of July 20, 2009.

3. The rules provide that certain violations of law, negligent conduct, reckless violations of professional standards, or lack of qualifications to perform auditing services may be considered good cause.

4. See the Federal Reserve's rules on disciplinary actions against public accountants and accounting firms at 12 CFR 263.94 and 12 CFR 263, subpart J.

stances. Also, an accountant or accounting firm is prohibited from performing audit services for the covered institution if an authorized agency has taken such a disciplinary action against the accountant or firm, or if the SEC or the PCAOB has taken certain disciplinary action against the accountant or firm.

The amended rules reflect the agencies' increasing concern about the quality of audits and internal controls for financial reporting at insured depository institutions. The rules emphasize the importance of maintaining high quality in the audits of federally insured depository institutions' financial position and in the attestations of management assessments.

OBJECTIVES OF INTERNAL CONTROL

In general, good internal control exists when no one is in a position to make significant errors or perpetrate significant irregularities without timely detection. Therefore, a system of internal control should include those procedures necessary to ensure timely detection of failure of accountability, and such procedures should be performed by competent persons who have no incompatible duties. The following standards are encompassed within the description of internal control:

Existence of procedures. Existence of prescribed internal control procedures is necessary but not sufficient for effective internal control. Prescribed procedures that are not actually performed do nothing to establish control. Consequently, the examiner must give thoughtful attention not only to the prescribed set of procedures but also to the practices actually followed. This attention can be accomplished through inquiry, observation, testing, or a combination thereof.

Competent performance. For internal control to be effective, the required procedures must be performed by competent persons. Evaluation of competence undoubtedly requires some degree of subjective judgment because attributes such as intelligence, knowledge, and attitude are relevant. Thus, the examiner should be alert for indications that employees have failed so substantially to perform their duties that a serious question is raised concerning their abilities.

Independent performance. If employees who have access to assets also have access to the related accounting records or perform related review operations (or immediately supervise the activities of other employees who maintain the records or perform the review operations), they may be able to both perpetrate and conceal defalcations. Therefore, duties concerned with the custody of assets are incompatible with recordkeeping duties for those assets, and duties concerned with the performance of activities are incompatible with the authorization or review of those activities.

In judging the independence of a person, the examiner must avoid looking at that person as an individual and presuming the way in which that individual would respond in a given situation. For example, an individual may be the sole check signer and an assistant may prepare monthly bank reconcilement. If the assistant appears to be a competent person, it may seem that an independent reconcilement would be performed and anything amiss would be reported. Such judgments are potentially erroneous. There exist no established tests by which the psychological and economic independence of an individual in a given situation can be judged. The position must be evaluated, not the person. If the position in which the person acts is not an independent one in itself, then the work should not be presumed to be independent, regardless of the apparent competence of the person in question. In the example cited above, the function performed by the assistant should be viewed as if it were performed by the supervisor. Hence, incompatible duties are present in that situation.

PROCEDURES FOR COMPLETING ICQs

The implementation of selected ICQs and the evaluation of internal audit activities provide a basis for determining the adequacy of the bank's control environment. To reach conclusions required by the questionnaires, the examiner assigned to review a given internal control routine or area of bank operations should use any source of information necessary to ensure a full understanding of the prescribed system, including any potential weaknesses. Only when the examiner completely understands the bank's system can an assessment and evaluation be made of the effects of internal controls on the examination.

To reach conclusions concerning a specific section of an ICQ, the examiner should document and review the bank's operating systems and procedures by consulting all available sources of information and discussing them with appropriate bank personnel. Sources of information might include organization charts, procedural manuals, operating instructions, job specifications, directives to employees, and other similar sources of information. Also, the examiner should not overlook potential sources such as job descriptions, flow charts, and other documentation in the internal audit workpapers. A primary objective in the review of the system is to efficiently reach a conclusion about the overall adequacy of existing controls. Any existing source of information that will enable the examiner to quickly gain an understanding of the procedures in effect should be used in order to minimize the time required to formulate the conclusions. The review should be documented in an organized manner through the use of narrative descriptions, flow charts, or other diagrams. If a system is properly documented, the documentation will provide a ready reference for any examiner performing work in the area, and it often may be carried forward for future examinations, which will save time.

Although narrative descriptions can often provide an adequate explanation of systems of internal control, especially in less complex situations, they may have certain drawbacks, such as the following:

- They may be cumbersome and too lengthy.
- They may be unclear or poorly written.
- Related points may be difficult to integrate.
- Annual changes may be awkward to record.

To overcome these problems, the examiner should consider using flow charts, which reduce narrative descriptions to a picture. Flow charts often reduce a complex situation to an easily understandable sequence of interrelated steps.

In obtaining and substantiating the answers to the questions in the ICQ, the examiner should develop a plan to obtain the necessary information efficiently. Such a plan would normally avoid a direct question-and-answer session with bank officers. A suggested approach to completion of the ICQ is to—

- become familiar with the ICQ,
- review related internal audit procedures, reports, and responses,
- review any written documentation of a bank's system of controls,
- find out what the department does and what the functions of personnel within the department are through conversations with appropriate individuals, and
- answer as many individual questions as possible from information gained in the preceding steps and fill in the remaining questions by direct inquiry.

An effective way to begin an on-site review of internal control is to identify the various key functions applicable to the area under review. For each position identified, the following questions should then be asked:

- Is this a critical position? That is, can a person in this position either make a significant error that will affect the recording of transactions or perpetrate material irregularities of some type?
- If an error is made or an irregularity is perpetrated, what is the probability that normal routines will disclose it on a timely basis? That is, what controls exist that would prevent or detect significant errors or the perpetration of significant irregularities?
- What are the specific opportunities open to the individual to conceal any irregularity, and are there any mitigating controls that will reduce or eliminate these opportunities?

Although all employees within an organization may be subject to control, not all have financial responsibilities that can influence the accuracy of the accounting and financial records or have access to assets. The examiner should be primarily concerned with those positions that have the ability to influence the records and that have access to assets. Once those positions have been identified, the examiners must exercise their professional knowledge of bank operations to visualize the possibilities open to any person holding a particular position. The question is not whether the individual is honest, but rather whether situations exist that might permit an error to be concealed. By directing attention to such situations, an examiner will also consider situations that may permit unintentional errors to remain undetected.

The evaluation of internal control should include consideration of other existing accounting and administrative controls or other circumstances that might counteract or mitigate an apparent weakness or impair an established control. Controls that mitigate an apparent weakness may be a formal part of the bank's operating system, such as budget procedures that include a careful comparison of budgeted and actual amounts by competent management personnel. Mitigating controls also may be informal. For example, in small banks, management may be sufficiently involved in daily operations to know the purpose and reasonableness of all expense disbursements. That knowledge, coupled with the responsibility for signing checks, may make irregularities by nonmanagement personnel unlikely, even if disbursements are otherwise under the control of only one person.

When reviewing internal controls, an essential part of the examination is being alert to indications that adverse circumstances may exist. Adverse circumstances may lead employees or officers into courses of action they normally would not pursue. An adverse circumstance to which the examiner should be especially alert exists when the personal financial interests of key officers or employees depend directly on operating results or financial condition. Although the review of internal control does not place the examiner in the role of an investigator or detective, an alert attitude toward possible conflicts of interest should be maintained throughout the examination. Also, offices staffed by members of the same family, branches completely dominated by a strong personality, or departments in which supervisors rely unduly on their assis-tants require special alertness on the part of the examiner. Those circumstances and other similar ones should be considered in preparing the ICQ. It is not the formality of the particular factor that is of importance but rather its effect on the overall operation under review. Circumstances that may affect answers to the basic questions should be noted along with conclusions concerning their effect on the examination.

The ICQs were designed so that answers could be substantiated by (1) inquiry to bank personnel, (2) observation, or (3) testing. However, certain questions are marked with an asterisk to indicate that they require substantiation through observation or testing. Those questions are deemed so critical that substantiation by inquiry is not sufficient. For those questions substantiated through testing, the nature and extent of the test performed should be indicated adjacent to the applicable step in the ICQ.

The examiner should be alert for deviations by bank personnel from established policies, practices, and procedures. This applies not only to questions marked with an asterisk but also to every question in the ICQ. Examples of such deviations include situations when (1) instructions and directives are frequently not revised to reflect current practices, (2) employees find shortcuts for performing their tasks, (3) changes in organization and activities may influence operating procedures in unexpected ways, or (4) employees' duties may be rotated in ways that have not been previously considered. These and other circumstances may serve to modify or otherwise change prescribed procedures, thus giving the examiner an inadequate basis for evaluating internal control.

Sometimes, when a substantial portion of the accounting work is accomplished by computer, the procedures are so different from conventional accounting methods that the principles discussed here seem inapplicable. Care should be taken to resist drawing this conclusion. This discussion of internal control and its evaluation is purposely stated in terms sufficiently general to apply to any system. Perpetration of defalcations requires direct or indirect access to appropriate documents or accounting records. As such, perpetration requires the involvement of people and, under any system, computerized or not, there will be persons who have access to assets and records. Those with access may include computer operators, programmers, and their supervisors and other related personnel.

The final question in each section of the ICQ requires a composite evaluation of existing internal controls in the applicable area of the bank. The examiner should base that evaluation on answers to the preceding questions within the section, the review and observation of the systems and controls within the bank, and discussion with appropriate bank personnel.

The composite evaluation does, however, require some degree of subjective judgment. The examiner should use all information available to formulate an overall evaluation, fully realizing that a high degree of professional judgment is required.

Applying the ICQ to Different Situations

The ICQs are general enough to apply to a wide range of systems, so not all sections or questions will apply to every situation, depending on factors such as bank size, complexity and type of operations, and organizational structure. When completing the ICQs, the examiner should include a brief comment stating the reason a section or question is not applicable to the specific situation.

For large banking institutions or when multiple locations of a bank are being examined, it may be necessary to design supplements to the ICQs to adequately review all phases of the bank's operations and related internal controls. Because certain functions described in this manual may be performed by several departments in some banks, it also may be necessary to redesign a particular section of the ICQ so that each department receives appropriate consideration. Conversely, functions described in several different sections of this handbook may be performed in a single department in smaller banks. If the ICQ is adapted to fit a specific situation, care should be taken to ensure that its scope and intent are not modified. That requires professional judgment in interpreting and expanding the generalized material. Any such modifications should be completely documented and filed in the workpapers.

LEGAL REQUIREMENTS AFFECTING BANKS AND THE AUDIT FUNCTION

The Federal Deposit Insurance Corporation Improvement Act of 1991 amended section 36 of the FDI Act (12 USC 1831m). Since then, the FDIC has made various revisions to its rules at Part 363 (12 CFR 363) and guidelines. When specific reports are required to be submitted to the FDIC to comply with the provisions of compliance with Part 363, the institution must also submit the report to the appropriate federal banking agency and any appropriate state supervisor.

For the purposes of determining the applicability of this rule, an institution should use total assets as reported on its most recent Report of Condition (the Call Report), the date that coincides with the end of the preceding fiscal year. If the fiscal year ends on a date other than the end of a calendar quarter, the institution is to use the Call Report for the quarter end immediately preceding the end of the fiscal year.

Institutions with $500 Million or More in Total Assets

The regulations require these institutions to file two copies of their annual reports with the FDIC, as well as with the appropriate federal banking agency and the appropriate state supervisory agency, that must include the following:

- Audited comparative annual financial statements;
- The independent public accountant's report on the audited financial statements;
- A management report (comprising its statements and assessments) that is signed by the chief executive officer and chief accounting or chief financial officer. The report should include:
  - — A statement of management's responsibilities for:
    - preparing the annual financial statements;
    - establishing and maintaining an adequate internal control structure and procedures over financial reporting;
    - complying with designated safety-and-soundness laws and regulations pertaining to insider loans and dividend restrictions; and
  - — An assessment by management of:
    - compliance with the designated safety-and-soundness laws and regulations pertaining to insider loans and dividend restrictions during the year, which must state management's conclusions regarding compliance and disclose any noncompliance with these laws and regulations.[5] (See SR-13-11.)

If the institution is a public company or a subsidiary of a public company that would be subject to the provisions of section 404 of the Sarbanes-Oxley Act (Section 404), it must comply with the requirement to file other reports issued by the independent accountant as set forth in section 363.4(c) (12 CFR 363.4(c)). The

5. See appendix B of 12 CFR part 363 for further details and illustrative examples of the appropriate wording for the management report.

institutions must provide a copy of the independent accountant's report to the FDIC on the audit of internal control over financial reporting that is required by section 404 with the FDIC within 15 days after receipt. The institutions also are encouraged to submit a copy of management's section 404 report on internal control over financial reporting together with the independent public accountant's internal control report.

Institutions with $1 Billion or More in Total Assets

Section 36 of the FDI Act and Part 363 of the FDIC's regulations required insured depository institutions with a least $1 billion in total assets to file two copies of additional reports that must include the following:

- Assessments by management of the effectiveness of the institution's internal control structure and procedures over financial reporting as of the end of the fiscal year (12 USC 1831m(b)(2)(B)(i); and
- The independent public accountant's attestation report—the independent public accountant is to examine, attest to, and report separately in an attestation report, on the assertions by management's concerning the institution's internal control structure and procedures for financial reporting (12 USC 1831m(c)). This includes the Call Report and the FR Y-9C report. The attestation is to be made in accordance with generally accepted standards for attestation engagements.

Other Requirements—Institutions with $500 Million or More in Total Assets

Financial reporting encompasses, for the purposes of Part 363, both financial statements prepared in accordance with generally accepted accounting principles and those prepared for regulatory reporting purposes. Each institution is to have an independent public accountant perform an audit who reports on the institution's annual financial statements in accordance with generally accepted auditing standards and section 37 of the FDI Act (12 USC 1831n). The scope of the audit engagement must be sufficient to permit the accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles. The audit is to be performed using procedures that will objectively determine the accuracy of management's assertions on compliance with safety-and-soundness laws and regulations (12 USC 1831m (b)(2)(A)(iii)).

In addition, each institution is required to file a copy of any management letter, qualification, or any other report issued by its independent public accountant with the FDIC within 15 days of receipt of such letter or report. See section 363.4(c) (12 CFR 363.4(c)).

Each institution is required to establish an audit committee of its board of directors. The duties of the audit committee include reviewing with management and the independent public accountant the basis for, and the results of, the annual independent audit reports and the institution's respective reporting requirements. Each institution with total assets of $1 billion or more, as of the beginning of the fiscal year, is required to have an audit committee, the members of which must be outside directors who are independent of the institution's management. Institutions with total assets of $500 million, but less than $1 billion or more, as of the beginning of the fiscal year, must have an audit committee, the members of which are outside directors, the majority of whom must be independent of the institution's management.

Reporting Requirements for Subsidiaries of Holding Companies

Under the FDIC rules, an insured depository institution that is a subsidiary of a holding company may file its audited financial statements at the holding company level (top-tier or mid-tier) if the holding company has total insured depository institution assets comprising 75 percent or more of the holding company's consolidated assets as of the beginning of the fiscal year. Furthermore, in accordance with 12 CFR part 363, the other reporting requirements can be satisfied at the holding company level if the holding company provides services and functions comparable to the insured depository institution, and the insured depository subsidiary (a) has less than $5 billion in total assets or (b) has a CAMELS composite rating of "1" or "2" when its total assets are $5 billion or more.

In order to facilitate effective and prudential supervision of the holding company, a holding company that has institutions subject to the FDIC rules must submit one copy of the required reports to the appropriate Federal Reserve Bank regardless of whether or not the holding company submitted these reports on a consolidated basis for its insured depository subsidiaries, and regardless of the charter of the insured depository subsidiary under the holding company. Refer to SR letter 94-3, "Supervisory Guidance on the Implementation of Section 112 of the FDIC Improvement Act," for further guidance on this filing requirement. (See SR-13-11.)

Required Management Report Signatures

As specified in 12 CFR part 363, an insured depository institution and holding company must adhere to the following signature requirements:

- If the audited financial statements and the management report requirements are satisfied entirely at the insured depository institution level, the management report must be signed by the CEO, as well as the CAO or CFO, at the insured depository institution level.
- If the audited financial statements and the management report requirements are satisfied entirely at the holding company level, the management report must be signed by the CEO, as well as the CAO or CFO, at the holding company level.
- If the audited financial statement requirements are satisfied at the holding company level and the management report requirement is satisfied at the insured depository institution level or one or more component requirements are satisfied at the holding company and the remaining component requirements are satisfied at the insured depository institution level, the management report must be signed by the CEO, as well as the CAO or CFO, of both the holding company and the insured depository institution.

INTERAGENCY POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve and other federal banking agencies[6] (the agencies) adopted on March 17, 2003, an interagency policy statement addressing the internal audit function and its outsourcing. The policy statement revises and replaces the former 1997 policy statement and incorporates recent developments in internal auditing. In addition, the revised policy incorporates guidance on the independence of accountants who provide institutions with both internal and external audit services in light of the Sarbanes-Oxley Act of 2002 (the act) and associated SEC rules.

The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit services to the company. The policy statement discusses the applicability of this prohibition to institutions that are public companies, to insured depository institutions with assets of $500 million or more that are subject to the annual audit and reporting requirements of section 36 of the FDI Act, and to nonpublic institutions that are not subject to section 36.

The statement recognizes that many institutions have engaged independent public accounting firms and other outside professionals (outsourcing vendors) to perform work that traditionally has been done by internal auditors. These arrangements are often called "internal audit outsourcing," "internal audit assistance," "audit co-sourcing," and "extended audit services" (hereafter collectively referred to as outsourcing). Typical outsourcing arrangements are more fully described below.

Outsourcing may be beneficial to an institution if it is properly structured, carefully conducted, and prudently managed. However, the structure, scope, and management of some internal audit outsourcing arrangements may not contribute to the institution's safety and soundness. Furthermore, arrangements with outsourcing vendors should not leave directors and senior management with the erroneous impression that they have been relieved of their responsibility for maintaining an effective system of internal control and for overseeing the internal audit function.

6. The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency.

Internal Audit Function (Part I)

Board and Senior Management Responsibilities

The board of directors and senior management are responsible for having an effective system of internal control and an effective internal audit function in place at their institution. They are also responsible for ensuring that the importance of internal control is understood and respected throughout the institution. This overall responsibility cannot be delegated to anyone else. They may, however, delegate the design, implementation, and monitoring of specific internal controls to lower-level management and delegate the testing and assessment of internal controls to others. Accordingly, directors and senior management should have reasonable assurance that the system of internal control prevents or detects significant inaccurate, incomplete, or unauthorized transactions; deficiencies in the safeguarding of assets; unreliable financial reporting (which includes regulatory reporting); and deviations from laws, regulations, and the institution's policies.[7]

Some institutions have chosen to rely on so-called management self-assessments or control self-assessments, wherein business-line managers and their staff evaluate the performance of internal controls within their purview. Such reviews help to underscore management's responsibility for internal control, but they are not impartial. Directors and members of senior management who rely too much on these reviews may not learn of control weaknesses until they have become costly problems, particularly if directors are not intimately familiar with the institution's operations. Therefore, institutions generally should also have their internal controls tested and evaluated by units without business-line responsibilities, such as internal audit groups.

Directors should be confident that the internal audit function addresses the risks of and meets the demands posed by the institution's current and planned activities. To accomplish this objective, directors should consider whether their institution's internal audit activities are conducted in accordance with professional standards, such as the Institute of Internal Auditors' (IIA) *Standards for the Professional Practice of Internal Auditing*. These standards address independence, professional proficiency, scope of work, performance of audit work, management of internal audit, and quality-assurance reviews. Furthermore, directors and senior management should ensure that the following matters are reflected in their institution's internal audit function.

Structure. Careful thought should be given to the placement of the audit function in the institution's management structure. The internal audit function should be positioned so that the board has confidence that the internal audit function will perform its duties with impartiality and not be unduly influenced by managers of day-to-day operations. The audit committee,[8] using objective criteria it has established, should oversee the internal audit function and evaluate its performance.[9] The audit committee should assign responsibility for the internal audit function to a member of management (that is, the manager of internal audit or internal audit manager) who understands the function and has no responsibility for operating the system of internal control. The ideal organizational arrange-

7. As noted above, under section 36 of the FDI Act, as implemented by part 363 of the FDIC's regulations (12 CFR 363), FDIC-insured depository institutions with total assets of $500 million or more must submit an annual management report signed by the chief executive officer (CEO) and chief accounting or chief financial officer. This report must contain (1) a statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with designated laws and regulations relating to safety and soundness, including management's assessment of the institution's compliance with those laws and regulations, and (2) for an institution with total assets of $1 billion or more at the beginning of the institution's most recent fiscal year, an assessment by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year. (See 12 CFR 363.2(b) and 70 *Fed. Reg.* 71,232, Nov. 28, 2005.)

8. Depository institutions subject to section 36 of the FDI Act and part 363 of the FDIC's regulations must maintain independent audit committees (i.e., consisting of directors who are not members of management). Consistent with the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, the agencies also encourage the board of directors of each depository institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors. Where the term *audit committee* is used in this policy statement, the board of directors may fulfill the audit committee responsibilities if the institution is not subject to an audit committee requirement. See *Fed. Reg.,* September 28, 1999 (64 FR 52,319).

9. For example, the performance criteria could include the timeliness of each completed audit, a comparison of overall performance to plan, and other measures.

ment is for this manager to report directly and solely to the audit committee regarding both audit issues and administrative matters, for example, resources, budget, appraisals, and compensation. Institutions are encouraged to consider the IIA's *Practice Advisory 2060-2: Relationship with the Audit Committee,* which provides more guidance on the roles and relationships between the audit committee and the internal audit manager.

Many institutions place the manager of internal audit under a dual reporting arrangement: the manager is functionally accountable to the audit committee on issues discovered by the internal audit function, while reporting to another senior manager on administrative matters. Under a dual reporting relationship, the board should consider the potential for diminished objectivity on the part of the internal audit manager with respect to audits concerning the executive to whom he or she reports. For example, a manager of internal audit who reports to the chief financial officer (CFO) for performance appraisal, salary, and approval of department budgets may approach audits of the accounting and treasury operations controlled by the CFO with less objectivity than if the manager were to report to the chief executive officer. Thus, the chief financial officer, controller, or other similar officer should ideally be excluded from overseeing the internal audit activities even in a dual role. The objectivity and organizational stature of the internal audit function are best served under such a dual arrangement if the internal audit manager reports administratively to the CEO.

Some institutions seek to coordinate the internal audit function with several risk-monitoring functions (for example, loan-review, market-risk-assessment, and legal compliance departments) by establishing an administrative arrangement under one senior executive. Coordination of these other monitoring activities with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. Such an administrative reporting relationship should be designed so as to not interfere with or hinder the manager of internal audit's functional reporting to and ability to directly communicate with the institution's audit committee. In addition, the audit committee should ensure that efforts to coordinate these monitoring functions do not result in the manager of internal audit conducting control activities nor diminish his or her independence with respect to the other risk-monitoring functions. Furthermore, the internal audit manager should have the ability to independently audit these other monitoring functions.

In structuring the reporting hierarchy, the board should weigh the risk of diminished independence against the benefit of reduced administrative burden in adopting a dual reporting organizational structure. The audit committee should document its consideration of this risk and mitigating controls. The IIA's *Practice Advisory 1110-2: Chief Audit Executive Reporting Lines* provides additional guidance regarding functional and administrative reporting lines.

Management, staffing, and audit quality. In managing the internal audit function, the manager of internal audit is responsible for control risk assessments, audit plans, audit programs, and audit reports.

- A control risk assessment (or risk-assessment methodology) documents the internal auditor's understanding of the institution's significant business activities and their associated risks. These assessments typically analyze the risks inherent in a given business line, the mitigating control processes, and the resulting residual risk exposure of the institution. They should be updated regularly to reflect changes to the system of internal control or work processes and to incorporate new lines of business.
- An internal audit plan is based on the control risk assessment and typically includes a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.
- An internal audit program describes the objectives of the audit work and lists the procedures that will be performed during each internal audit review.
- An audit report generally presents the purpose, scope, and results of the audit, including findings, conclusions, and recommendations. Workpapers that document the work performed and support the audit report should be maintained.

Ideally, the internal audit function's only role should be to independently and objectively evaluate and report on the effectiveness of an institution's risk-management, control, and governance processes. Internal auditors increasingly have taken a consulting role within institutions on new products and services and on mergers, acquisitions, and other corporate reorganizations. This role typically includes helping design controls and participating in the implementation of changes to the institution's control activities. The audit committee, in its oversight of the internal audit staff, should ensure that the function's consulting activities do not interfere or conflict with the objectivity it should have with respect to monitoring the institution's system of internal control. In order to maintain its independence, the internal audit function should not assume a business-line management role over control activities, such as approving or implementing operating policies or procedures, including those it has helped design in connection with its consulting activities. The agencies encourage internal auditors to follow the IIA's standards, including guidance related to the internal audit function acting in an advisory capacity.

The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and assess whether internal controls are effective. The manager of internal audit should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide the audit staff. The form and content of these policies and procedures should be consistent with the size and complexity of the department and the institution. Many policies and procedures may be communicated informally in small internal audit departments, while larger departments would normally require more formal and comprehensive written guidance.

Scope. The frequency and extent of internal audit review and testing should be consistent with the nature, complexity, and risk of the institution's on- and off-balance-sheet activities. At least annually, the audit committee should review and approve internal audit's control risk assessment and the scope of the audit plan, including how much the manager relies on the work of an outsourcing vendor. It should also periodically review internal audit's adherence to the audit plan. The audit committee should consider requests for expansion of basic internal audit work when significant issues arise or when significant changes occur in the institution's environment, structure, activities, risk exposures, or systems.[10]

Communication. To properly carry out their responsibility for internal control, directors and senior management should foster forthright communications and critical examination of issues to better understand the importance and severity of internal control weaknesses identified by the internal auditor and operating management's solutions to these weaknesses. Internal auditors should report internal control deficiencies to the appropriate level of management as soon as they are identified. Significant matters should be promptly reported directly to the board of directors (or its audit committee) and senior management. In periodic meetings with management and the manager of internal audit, the audit committee should assess whether management is expeditiously resolving internal control weaknesses and other exceptions. Moreover, the audit committee should give the manager of internal audit the opportunity to discuss his or her findings without management being present.

Furthermore, each audit committee should establish and maintain procedures for employees of their institution to confidentially and anonymously submit concerns to the committee about questionable accounting, internal accounting control, or auditing matters.[11] In addition, the audit committee should set up procedures for the timely investigation of complaints received and the retention for a reasonable time period of documentation concerning the complaint and its subsequent resolution.

Contingency planning. As with any other function, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas. Lack of contingency planning for continuing internal audit coverage may increase the institution's level of operational risk.

10. Major changes in an institution's environment and conditions may compel changes to the internal control system and also warrant additional internal audit work. These changes include (1) new management; (2) areas or activities experiencing rapid growth or rapid decline; (3) new lines of business, products, or technologies or disposals thereof; (4) corporate restructurings, mergers, and acquisitions; and (5) an expansion or acquisition of foreign operations (including the impact of changes in the related economic and regulatory environments).

11. When the board of directors fulfills the audit committee responsibilities, the procedures should provide for the submission of employee concerns to an outside director.

Small Financial Institution's Internal Audit Function

An effective system of internal control and an independent internal audit function form the foundation for safe and sound operations, regardless of an institution's size. Each institution should have an internal audit function that is appropriate to its size and the nature and scope of its activities. The procedures assigned to this function should include adequate testing and review of internal controls and information systems.

It is the responsibility of the audit committee and management to carefully consider the extent of auditing that will effectively monitor the internal control system, after taking into account the internal audit function's costs and benefits. For institutions that are large or have complex operations, the benefits derived from a full-time manager of internal audit or an auditing staff likely outweigh the cost. For small institutions with few employees and less complex operations, however, these costs may outweigh the benefits. Nevertheless, a small institution without an internal auditor can ensure that it maintains an objective internal audit function by implementing a comprehensive set of independent reviews of significant internal controls. The key characteristic of such reviews is that the persons directing and/or performing the review of internal controls are *not* also responsible for managing or operating those controls. A person who is competent in evaluating a system of internal control should design the review procedures and arrange for their implementation. The person responsible for reviewing the system of internal control should report findings directly to the audit committee. The audit committee should evaluate the findings and ensure that senior management has or will take appropriate action to correct the control deficiencies.

Internal Audit Outsourcing Arrangements (Part II)

Examples of Internal Audit Outsourcing Arrangements

An outsourcing arrangement is a contract between an institution and an outsourcing vendor to provide internal audit services. Outsourcing arrangements take many forms and are used by institutions of all sizes. Some institutions consider entering into these arrangements to enhance the quality of their control environment by obtaining the services of a vendor with the knowledge and skills to critically assess, and recommend improvements to, their internal control systems. The internal audit services under contract can be limited to helping internal audit staff in an assignment for which they lack expertise. Such an arrangement is typically under the control of the institution's manager of internal audit, and the outsourcing vendor reports to him or her. Institutions often use outsourcing vendors for audits of areas requiring more technical expertise, such as electronic data processing and capital-markets activities. Such uses are often referred to as "internal audit assistance" or "audit co-sourcing."

Some outsourcing arrangements may require an outsourcing vendor to perform virtually all the procedures or tests of the system of internal control. Under such an arrangement, a designated manager of internal audit oversees the activities of the outsourcing vendor and typically is supported by internal audit staff. The outsourcing vendor may assist the audit staff in determining risks to be reviewed and may recommend testing procedures, but the internal audit manager is responsible for approving the audit scope, plan, and procedures to be performed. Furthermore, the internal audit manager is responsible for the results of the outsourced audit work, including findings, conclusions, and recommendations. The outsourcing vendor may report these results jointly with the internal audit manager to the audit committee.

Additional Considerations for Internal Audit Outsourcing Arrangements

Even when outsourcing vendors provide internal audit services, the board of directors and senior management of an institution are responsible for ensuring that both the system of internal control and the internal audit function operate effectively. In any outsourced internal audit arrangement, the institution's board of directors and senior management must maintain ownership of the internal audit function and provide active oversight of outsourced activities. When negotiating the outsourcing arrangement with an outsourcing vendor, an institution should carefully consider its current and anticipated business risks in setting each party's internal audit responsibilities. The outsourcing arrangement should not increase the risk that a breakdown of internal control will go undetected.

To clearly distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, often taking the form of an engagement letter.[12] Contracts between the institution and the vendor typically include provisions that—

- define the expectations and responsibilities under the contract for both parties;
- set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor;
- set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work;
- establish the process for changing the terms of the service contract, especially for expansion of audit work if significant issues are found, and stipulations for default and termination of the contract;
- state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor;
- specify the locations of internal audit reports and the related workpapers;
- specify the period of time (for example, seven years) that vendors must maintain the workpapers;[13]
- state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor;
- prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence; and
- state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management or an employee and, if applicable, will comply with AICPA, U.S. Securities and Exchange Commission (SEC), PCAOB, or regulatory independence guidance.

Vendor competence. Before entering an outsourcing arrangement, the institution should perform due diligence to satisfy itself that the outsourcing vendor has sufficient staff qualified to perform the contracted work. The staff's qualifications may be demonstrated, for example, through prior experience with financial institutions. Because the outsourcing arrangement is a personal-services contract, the institution's internal audit manager should have confidence in the competence of the staff assigned by the outsourcing vendor and receive timely notice of key staffing changes. Throughout the outsourcing arrangement, management should ensure that the outsourcing vendor maintains sufficient expertise to effectively perform its contractual obligations.

Management of the outsourced internal audit function. Directors and senior management should ensure that the outsourced internal audit function is competently managed. For example, larger institutions should employ sufficient competent staff members in the internal audit department to assist the manager of internal audit in overseeing the outsourcing vendor. Small institutions that do not employ a full-time audit manager should appoint a competent employee who ideally has no managerial responsibility for the areas being audited to oversee the outsourcing vendor's performance under the contract. This person should report directly to the audit committee for purposes of communicating internal audit issues.

Communication when an outsourced internal audit function exists. Communication between the internal audit function and the audit committee and senior management should not

12. The engagement-letter provisions described are comparable to those outlined by the American Institute of Certified Public Accountants (AICPA) for financial statement audits. (See AICPA Professional Standards, AU section 310.) These provisions are consistent with the provisions customarily included in contracts for other outsourcing arrangements, such as those involving data processing and information technology. Therefore, the federal banking agencies consider these provisions to be usual and customary business practices.

13. If the workpapers are in electronic format, contracts often call for the vendor to maintain proprietary software that enables the bank and examiners to access the electronic workpapers for a specified time period.

diminish because the institution engages an outsourcing vendor. All work by the outsourcing vendor should be well documented and all findings of control weaknesses should be promptly reported to the institution's manager of internal audit. Decisions not to report the outsourcing vendor's findings to directors and senior management should be the mutual decision of the internal audit manager and the outsourcing vendor. In deciding what issues should be brought to the board's attention, the concept of "materiality," as the term is used in financial statement audits, is generally not a good indicator of which control weakness to report. For example, when evaluating an institution's compliance with laws and regulations, any exception may be important.

Contingency planning to ensure continuity of outsourced audit coverage. When an institution enters into an outsourcing arrangement (or significantly changes the mix of internal and external resources used by internal audit), it may increase its operational risk. Because the arrangement may be terminated suddenly, the institution should have a contingency plan to mitigate any significant discontinuity in audit coverage, particularly for high-risk areas.

Independence of the Independent Public Accountant (Part III)

The following discussion applies only when a financial institution is considering using a public accountant to provide both external audit and internal audit services to the institution.

When one accounting firm performs both the external audit and the outsourced internal audit function, the firm risks compromising its independence. These concerns arise because, rather than having two separate functions, this outsourcing arrangement places the independent public accounting firm in the position of appearing to audit, or actually auditing, its own work. For example, in auditing an institution's financial statements, the accounting firm will consider the extent to which it may rely on the internal control system, including the internal audit function, in designing audit procedures.

Applicability of the SEC's Auditor Independence Requirements

Institutions that are public companies. To strengthen auditor independence, Congress passed the Sarbanes-Oxley Act of 2002 (the act). Title II of the act applies to any public company—that is, any company that has a class of securities registered with the SEC or the appropriate federal banking agency under section 12 of the Securities Exchange Act of 1934 or that is required to file reports with the SEC under section 15(d) of that act.[14] The act prohibits an accounting firm from acting as the external auditor of a public company during the same period that the firm provides internal audit outsourcing services to the company.[15] In addition, if a public company's external auditor will be providing auditing services and permissible nonaudit services, such as tax services, the company's audit committee must preapprove each of these services.

According to the SEC's final rules (effective May 6, 2003) implementing the act's nonaudit-service prohibitions and audit committee preapproval requirements, an accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides internal audit outsourcing or other prohibited nonaudit services to the public company audit client. The SEC's final rules generally become effective on May 6, 2003, although there is a one-year transition period if the accountant is performing prohibited nonaudit services and external audit services for a public

14. 15 USC 78*l* and 78o(d).

15. In addition to prohibiting internal audit outsourcing, the Sarbanes-Oxley Act (15 USC 78j-1) also identifies other nonaudit services that an external auditor is prohibited from providing to a public company whose financial statements it audits. The legislative history of the act indicates that three broad principles should be considered when determining whether an auditor should be prohibited from providing a nonaudit service to an audit client. These principles are that an auditor should not (1) audit his or her own work, (2) perform management functions for the client, or (3) serve in an advocacy role for the client. To do so would impair the auditor's independence. Based on these three broad principles, the other nonaudit services that an auditor is prohibited from providing to a public company audit client include bookkeeping or other services related to the client's accounting records or financial statements; financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports; actuarial services; management or human resources functions; broker or dealer, investment adviser, or investment banking services; legal services and expert services unrelated to the audit; and any other service determined to be impermissible by the PCAOB.

company pursuant to a contract in existence on May 6, 2003. The services provided during this transition period must not have impaired the auditor's independence under the preexisting independence requirements of the SEC, the Independence Standards Board, and the AICPA. Although the SEC's pre-Sarbanes-Oxley independence requirements (issued in November 2000, effective August 2002) did not prohibit the outsourcing of internal audit services to a public company's independent public accountant, they did place conditions and limitations on internal audit outsourcing.

Depository institutions subject to the annual audit and reporting requirements of section 36 of the FDI Act. Under section 36, as implemented by part 363 of the FDIC's regulations, each FDIC-insured depository institution with total assets of $500 million or more is required to have an annual audit performed by an independent public accountant.[16] The part 363 guidelines address the qualifications of an independent public accountant engaged by such an institution by stating that "[t]he independent public accountant should also be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff."[17]

Thus, the guidelines provide for each FDIC-insured depository institution with $500 million or more in total assets, whether or not it is a public company, and its external auditor to comply with the SEC's auditor independence requirements that are in effect during the period covered by the audit. These requirements include the nonaudit-service prohibitions and audit committee preapproval requirements implemented by the SEC's January 2003 auditor independence rules once these rule come into effect.[18]

Institutions not subject to section 36 of the FDI Act that are neither public companies nor subsidiaries of public companies. The agencies have long encouraged each institution not subject to section 36 of the FDI Act that is neither a public company nor a subsidiary of a public company[19] to have its financial statements audited by an independent public accountant.[20] The agencies also encourage each such institution to follow the internal audit outsourcing prohibition in the Sarbanes-Oxley Act, as discussed above for institutions that are public companies.

As previously mentioned, some institutions seek to enhance the quality of their control environment by obtaining the services of an outsourcing vendor who can critically assess their internal control system and recommend improvements. The agencies believe that a small nonpublic institution with less complex operations and limited staff can, in certain circumstances, use the same accounting firm to perform both an external audit and some or all of the institution's internal audit activities. These circumstances include, but are not limited to, situations in which—

- splitting the audit activities poses significant costs or burden;
- persons with the appropriate specialized knowledge and skills are difficult to locate and obtain;
- the institution is closely held and investors are not solely reliant on the audited financial statements to understand the financial position and performance of the institution; and
- the outsourced internal audit services are limited in either scope or frequency.

In circumstances such as these, the agencies view an internal audit outsourcing arrangement between a small nonpublic institution and its external auditor as not being inconsistent with their safety-and-soundness objectives for the institution.

16. 12 CFR 363.3(a). (See FDIC Financial Institutions Letter FIL-17-2003 (Corporate Governance, Audits, and Reporting Requirements), attachment II, March 5, 2003.)

17. Appendix A to part 363, Guidelines and Interpretations, paragraph 14, Independence.

18. If a depository institution subject to section 36 and part 363 satisfies the annual independent audit requirement by relying on the independent audit of its parent holding company, once the SEC's January 2003 regulations prohibiting an external auditor from performing internal audit outsourcing services for an audit client take effect May 6, 2003, or May 6, 2004, depending on the circumstances, the holding company's external auditor cannot perform internal audit outsourcing work for that holding company or the subsidiary institution.

19. FDIC-insured depository institutions with less than $500 million in total assets are not subject to section 36 of the FDI Act. Section 36 does not apply directly to holding companies but provides that, for an insured depository institution that is a subsidiary of a holding company, the audited financial statements requirement and certain of the statute's other requirements may be satisfied by the holding company.

20. See, for example, the 1999 Interagency Policy Statement on External Auditing Programs of Banks and Savings Institutions.

When a small nonpublic institution decides to hire the same firm to perform internal and external audit work, the audit committee and the external auditor should pay particular attention to preserving the independence of both the internal and external audit functions. Furthermore, the audit committee should document both that it has preapproved the internal audit outsourcing to its external auditor and has considered the independence issues associated with this arrangement.[21] In this regard, the audit committee should consider the independence standards described in parts I and II of the policy statement, the AICPA guidance discussed below, and the broad principles that the auditor should not perform management functions or serve in an advocacy role for the client.

Accordingly, the agencies will not consider an auditor who performs internal audit outsourcing services for a small nonpublic audit client to be independent unless the institution and its auditor have adequately addressed the associated independence issues. In addition, the institution's board of directors and management must retain ownership of and accountability for the internal audit function and provide active oversight of the outsourced internal audit relationship.

A small nonpublic institution may be required by another law or regulation, an order, or another supervisory action to have its financial statements audited by an independent public accountant. In this situation, if warranted for safety-and-soundness reasons, the institution's primary federal regulator may require that the institution and its independent public accountant comply with the auditor-independence requirements of the act.[22]

AICPA guidance. As noted above, the independent public accountant for a depository institution subject to section 36 of the FDI Act also should be in compliance with the AICPA's *Code of Professional Conduct.* This code includes professional ethics standards, rules, and interpretations that are binding on all certified public accountants (CPAs) who are members of the AICPA in order for the member to remain in good standing. Therefore, this code applies to each member CPA who provides audit services to an institution, regardless of whether the institution is subject to section 36 or is a public company.

The AICPA has issued guidance indicating that a member CPA would be deemed not independent of his or her client when the CPA acts or appears to act in a capacity equivalent to a member of the client's management or as a client employee. The AICPA's guidance includes illustrations of activities that would be considered to compromise a CPA's independence. Among these are activities that involve the CPA authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client. For additional details, refer to Interpretation 101-3, Performance of Other Services, and Interpretation 101-13, Extended Audit Services, in the AICPA's *Code of Professional Conduct*.

Examination Guidance (Part IV)

Review of the Internal Audit Function and Outsourcing Arrangements

Examiners should have full and timely access to an institution's internal audit resources, including personnel, workpapers, risk assessments, work plans, programs, reports, and budgets. A delay may require examiners to widen the scope of their examination work and may subject the institution to follow-up supervisory actions.

Examiners should assess the quality and scope of an institution's internal audit function, regardless of whether it is performed by the institution's employees or by an outsourcing vendor. Specifically, examiners should consider whether—

- the internal audit function's control risk assessment, audit plans, and audit programs are appropriate for the institution's activities;
- the internal audit activities have been adjusted for significant changes in the institution's environment, structure, activities, risk exposures, or systems;
- the internal audit activities are consistent with the long-range goals and strategic direction of the institution and are responsive to its internal control needs;
- the audit committee promotes the internal audit manager's impartiality and indepen-

21. If a small nonpublic institution is considering having its external auditor perform other nonaudit services, its audit committee may wish to discuss the implications of the performance of these services on the auditor's independence.

22. 15 USC 78j-1.

dence by having him or her directly report audit findings to it;
- the internal audit manager is placed in the management structure in such a way that the independence of the function is not impaired;
- the institution has promptly responded to significant identified internal control weaknesses;
- the internal audit function is adequately managed to ensure that audit plans are met, programs are carried out, and the results of audits are promptly communicated to senior management and members of the audit committee and board of directors;
- workpapers adequately document the internal audit work performed and support the audit reports;
- management and the board of directors use reasonable standards, such as the IIA's *Standards for the Professional Practice of Internal Auditing*, when assessing the performance of internal audit; and
- the audit function provides high-quality advice and counsel to management and the board of directors on current developments in risk management, internal control, and regulatory compliance.

The examiner should assess the competence of the institution's internal audit staff and management by considering the education, professional background, and experience of the principal internal auditors. In addition, when reviewing outsourcing arrangements, examiners should determine whether—

- the arrangement maintains or improves the quality of the internal audit function and the institution's internal control;
- key employees of the institution and the outsourcing vendor clearly understand the lines of communication and how any internal control problems or other matters noted by the outsourcing vendor are to be addressed;
- the scope of the outsourced work is revised appropriately when the institution's environment, structure, activities, risk exposures, or systems change significantly;
- the directors have ensured that the outsourced internal audit activities are effectively managed by the institution;
- the arrangement with the outsourcing vendor satisfies the independence standards described in this policy statement and thereby preserves the independence of the internal audit function, whether or not the vendor is also the institution's independent public accountant; and
- the institution has performed sufficient due diligence to satisfy itself of the vendor's competence before entering into the outsourcing arrangement and has adequate procedures for ensuring that the vendor maintains sufficient expertise to perform effectively throughout the arrangement.

Examination concerns about the adequacy of the internal audit function. If the examiner concludes that the institution's internal audit function, whether or not it is outsourced, does not sufficiently meet the institution's internal audit needs; does not satisfy the Interagency Guidelines Establishing Standards for Safety and Soundness, if applicable; or is otherwise inadequate, he or she should determine whether the scope of the examination should be adjusted. The examiner should also discuss his or her concerns with the internal audit manager or other person responsible for reviewing the system of internal control. If these discussions do not resolve the examiner's concerns, he or she should bring these matters to the attention of senior management and the board of directors or audit committee. If the examiner finds material weaknesses in the internal audit function or the internal control system, he or she should discuss them with appropriate agency staff in order to determine the appropriate actions the agency should take to ensure that the institution corrects the deficiencies. These actions may include formal and informal enforcement actions.

The institution's management and composite ratings should reflect the examiner's conclusions regarding the institution's internal audit function. The report of examination should contain comments concerning the adequacy of this function, significant issues or concerns, and recommended corrective actions.

Concerns about the independence of the outsourcing vendor. An examiner's initial review of an internal audit outsourcing arrangement, including the actions of the outsourcing vendor, may raise questions about the institution's and its vendor's adherence to the independence standards described in parts I and II of the policy statement, whether or not the vendor is an accounting firm, and in part III if the vendor provides both external and internal audit services to the institution. In such cases, the examiner first should ask the institution and the outsourcing vendor how the audit committee determined that the vendor was independent. If the vendor is an accounting firm, the audit committee should be asked to demonstrate how it assessed that the arrangement has not compromised applicable SEC, PCAOB, AICPA, or other regulatory standards concerning auditor independence. If the examiner's concerns are not adequately addressed, the examiner should discuss the matter with appropriate agency staff prior to taking any further action.

If the agency staff concurs that the independence of the external auditor or other vendor appears to be compromised, the examiner will discuss his or her findings and the actions the agency may take with the institution's senior management, board of directors (or audit committee), and the external auditor or other vendor. In addition, the agency may refer the external auditor to the state board of accountancy, the AICPA, the SEC, the PCAOB, or other authorities for possible violations of applicable independence standards. Moreover, the agency may conclude that the institution's external auditing program is inadequate and that it does not comply with auditing and reporting requirements, including sections 36 and 39 of the FDI Act and related guidance and regulations, if applicable. *Issued jointly by the Board, FDIC, OCC, and OTS on March 17, 2003.*

SUPPLEMENTAL POLICY STATEMENT ON THE INTERNAL AUDIT FUNCTION AND ITS OUTSOURCING

The Federal Reserve issued this January 23, 2013, policy statement to supplement the guidance in the 2003 "Interagency Policy Statement on the Internal Audit Function and Its Outsourcing" (referred to as the 2003 Policy Statement).[23] Federal Reserve staff has identified areas for improving regulated institutions' internal audit functions. This supplemental policy statement addresses the characteristics, governance, and operational effectiveness of an institution's internal audit function. Further, this statement reflects certain changes in banking regulations that have occurred since the issuance of the 2003 Policy Statement. The Federal Reserve is providing this supplemental guidance to enhance regulated institutions' internal audit practices and to encourage them to adopt professional audit standards and other authoritative guidance, including those issued by the Institute of Internal Auditors (IIA).[24]

This supplemental statement applies to supervised institutions with greater than $10 billion in total consolidated assets, including state member banks, domestic bank and savings and loan holding companies, and U.S. operations of foreign banking organizations.[25] This supplemental guidance is also consistent with the objectives of the Federal Reserve's consolidated supervision framework for large financial institutions with total consolidated assets of $50 billion or more, which promotes an independent internal audit function as an essential element for enhancing the resiliency of supervised institutions.[26]

Overview—Assessment of the Effectiveness of the Internal Audit Function

The degree to which an institution implements the internal audit practices outlined in this policy statement will be considered in the Federal Reserve's supervisory assessment of the effectiveness of an institution's internal audit function as well as its safety and soundness and compliance with consumer laws and regulations. Moreover, the overall effectiveness of an institution's internal audit function will influence the ability of the Federal Reserve to rely upon the work of an institution's internal audit function.

This supplemental policy statement builds upon the 2003 Policy Statement, which remains in effect, and follows the same organizational structure, with a new section entitled "Enhanced

23. Refer to SR-03-5, "Amended Interagency Guidance on the Internal Audit Function and Its Outsourcing."

24. In this guidance, references have been provided to the IIA's International Standards for the Professional Practice of Internal Auditing (Standards). Refer to the IIA website at https://na.theiia.org/standards-guidance/pages/standards-and-guidance-ippf.aspx.

25. Section 4 of this document, however, clarifies certain changes to the Federal Deposit Insurance Corporation regulation (12 CFR part 363) on independence standards for independent public accountants at insured depository institutions with total assets of $500 million or more, which were adopted pursuant to 2009 amendments to section 36 of the FDI Act.

26. Refer to SR-12-17/CA letter 12-14, "Consolidated Supervision Framework for Large Financial Institutions."

Internal Audit Practices" and updates to Parts I-IV of the 2003 Policy Statement. Refer to SR-13-1/CA13-1 and its attachment. To avoid historical references and duplication some introductory paragraphs and other small phrases are omitted from the policy statement here, as indicated by a line of asterisks.

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SUPPLEMENTAL POLICY GUIDANCE

Enhanced Internal Audit Practices

An institution's internal audit function should incorporate the following enhanced practices into their overall processes:

Risk Analysis

Internal audit should analyze the effectiveness of all critical risk-management functions both with respect to individual risk dimensions (for example, credit risk), and an institution's overall risk-management function. The analysis should focus on the nature and extent of monitoring compliance with established policies and processes and applicable laws and regulations within the institution as well as whether monitoring processes are appropriate for the institution's business activities and the associated risks.

Thematic Control Issues

Internal audit should identify thematic macro control issues as part of its risk-assessment processes and determine the overall impact of such issues on the institution's risk profile. Additional audit coverage would be expected in business activities that present the highest risk to the institution. Internal audit coverage should reflect the identification of thematic macro control issues across the firm in all auditable areas. Internal audit should communicate thematic macro control issues to senior management and the audit committee.

In addition, internal audit should identify patterns of thematic macro control issues, determine whether additional audit coverage is required, communicate such control deficiencies to senior management and the audit committee, and ensure management establishes effective remediation mechanisms.

Challenging Management and Policy

Internal audit should challenge management to adopt appropriate policies and procedures and effective controls. If policies, procedures, and internal controls are ineffective or insufficient in a particular line of business or activity, internal audit should report specific deficiencies to senior management and the audit committee with recommended remediation. Such recommendations may include restricting business activity in affected lines of business until effective policies, procedures, and controls are designed and implemented. Internal audit should monitor management's corrective action and conduct a follow-up review to confirm that the recommendations of both internal audit and the audit committee have been addressed.

Infrastructure

When an institution designs and implements infrastructure enhancements, internal audit should review significant changes and notify management of potential internal control issues. In particular, internal audit should ensure that existing, effective internal controls (for example, software applications and management information system reporting) are not rendered ineffective as a result of infrastructure changes unless those controls are compensated for by other improvements to internal controls.

Risk Tolerance

Internal audit should understand risks faced by the institution and confirm that the board of directors and senior management are actively involved in setting and monitoring compliance with the institution's risk tolerance limits. Internal audit should evaluate the reasonableness of established limits and perform sufficient testing to ensure that management is operating within these limits and other restrictions.

Governance and Strategic Objectives

Internal audit should evaluate governance at all management levels within the institution, including at the senior management level, and within all significant business lines. Internal audit should also evaluate the adequacy and effectiveness of controls to respond to risks within the organization's governance, operations, and information systems in achieving the organization's strategic objectives. Any concerns should be communicated by internal audit to the board of directors and senior management.

Internal Audit Function *(Part I of the 2003 Policy Statement)*

The primary objectives of the internal audit function are to examine, evaluate, and perform an independent assessment of the institution's internal control system, and report findings back to senior management and the institution's audit committee. An effective internal audit function within a financial institution is a vital means for an institution's board of directors to maintain the quality of the internal control environment and risk-management systems.

The guidance set forth in this section supplements the existing guidance in the 2003 Policy Statement by strongly encouraging internal auditors to adhere to professional standards, such as the IIA guidance. Furthermore, this section clarifies certain aspects of the IIA guidance and provides practices intended to increase the safety and soundness of institutions.

Attributes of Internal Audit

Independence. Internal audit is an independent function that supports the organization's business objectives and evaluates the effectiveness of risk management, control, and governance processes. The 2003 Policy Statement addressed the structure of an internal audit function, noting that it should be positioned so that an institution's board of directors has confidence that the internal audit function can be impartial and not unduly influenced by managers of day-to-day operations. Thus, the member of management responsible for the internal audit function (hereafter referred to as the chief audit executive or CAE)[27] should have no responsibility for operating the system of internal control and should report functionally to the audit committee. A reporting arrangement may be used in which the CAE is functionally accountable and reports directly to the audit committee on internal audit matters (that is, the audit plan, audit findings, and the CAE's job performance and compensation) and reports administratively to another senior member of management who is not responsible for operational activities reviewed by internal audit. When there is an administrative reporting of the CAE to another member of senior management, the objectivity of internal audit is served best when the CAE reports administratively to the chief executive officer (CEO).

If the CAE reports administratively to someone other than the CEO, the audit committee should document its rationale for this reporting structure, including mitigating controls available for situations that could adversely impact the objectivity of the CAE. In such instances, the audit committee should periodically (at least annually) evaluate whether the CAE is impartial and not unduly influenced by the administrative reporting line arrangement. Further, conflicts of interest for the CAE and all other audit staff should be monitored at least annually with appropriate restrictions placed on auditing areas where conflicts may occur.

For foreign banking organizations (FBOs), the internal audit function for the U.S. operations of an FBO should have appropriate independent oversight for the total assets of U.S. operations.[28] When there is a resident U.S. audit function, the CAE of the U.S. audit function should report directly to senior officials of the internal audit department at the head office such as the global CAE. If the FBO has separate U.S. subsidiaries, oversight may be provided by a U.S. based audit committee that meets U.S. public company standards for independence or by the foreign parent company's internal audit function.

Professional competence and staffing. Internal audit staff should have the requisite collective

27. More recently, this title is used to refer to the person in charge of the internal audit function. An institution may not have a person at the management level of CAE and instead may have an internal audit manager.

28. This is defined as the combined total assets of U.S. operations, net of all intercompany assets and claims on U.S.-domiciled affiliates.

skill levels to audit all areas of the institution. Therefore, auditors should have a wide range of business knowledge, demonstrated through years of audit and industry-specific experience, educational background, professional certifications, training programs, committee participation, professional associations, and job rotational assignments. Internal audit should assign staff to audit assignments based on areas of expertise and, when feasible, rotate staff within the audit function.

Internal audit management should perform knowledge-gap assessments at least annually to evaluate whether current staff members have the knowledge and skills commensurate with the institution's strategy and operations. Management feedback surveys and internal or external quality assurance findings are useful tools to identify and assess knowledge gaps. Any identified knowledge gaps should be filled and may be addressed through targeted staff hires, training, business line rotation programs, and outsourcing arrangements. The internal audit function should have an effective staff training program to advance professional development and should have a process to evaluate and monitor the quality and appropriateness of training provided to each auditor. Internal auditors generally receive a minimum of forty hours of training in a given year.

Objectivity and ethics. Internal auditors should be objective, which means performing assignments free from bias and interference. A major characteristic of objectivity is that the CAE and all internal audit professional staff avoid any conflicts of interest.[29] For their first year in the internal audit function, internally recruited internal auditors should not audit activities for which they were previously responsible. Moreover, compensation schemes should not provide incentives for internal auditors to act contrary to the attributes and objectives of the internal audit function.[30] While an internal auditor may recommend internal control standards or review management's procedures before implementation, objectivity requires that the internal auditor not be responsible for the design, installation, procedures development, or operations of the institution's internal control systems.

An institution's internal audit function should have a code of ethics that emphasizes the principles of objectivity, competence, confidentiality, and integrity, consistent with professional internal audit guidance such as the code of ethics established by the IIA.

Internal audit charter. Each institution should have an internal audit charter that describes the purpose, authority, and responsibility of the internal audit function. An audit charter should include the following critical components:

- The objectives and scope of the internal audit function;
- The internal audit function's management reporting position within the organization, as well as its authority and responsibilities;
- The responsibility and accountability of the CAE; and
- The internal audit function's responsibility to evaluate the effectiveness of the institution's risk management, internal controls, and governance processes.

The charter should be approved by the audit committee of the institution's board of directors. The charter should provide the internal audit function with the authorization to access the institution's records, personnel, and physical properties relevant to the performance of internal audit procedures, including the authority to examine any activities or entities. Periodically, the CAE should evaluate whether the charter continues to be adequate, requesting the approval of the audit committee for any revisions. The charter should define the criteria for when and how the internal audit function may outsource some of its work to external experts.

Corporate Governance Considerations

Board of directors and senior management responsibilities. The board of directors and senior management are responsible for ensuring that the institution has an effective system of internal controls. As indicated in the 2003 Policy Statement, this responsibility cannot be delegated to others within the institution or to external parties. Further, the board of directors and senior management are responsible for ensuring that internal controls are operating effectively.

29. IIA standards define conflict of interest as a situation in which an internal auditor, who is in a position of trust, has a competing professional or personal interest. Such competing interests can make it difficult for the individual to fulfill his or her duties impartially.

30. IIA standards have additional examples of "conflict of interest" for consideration.

Audit committee responsibilities. An institution's audit committee is responsible for establishing an appropriate internal audit function and ensuring that it operates adequately and effectively. The audit committee should be confident that the internal audit function addresses the risks and meets the demands posed by the institution's current and planned activities. Moreover, the audit committee is expected to retain oversight responsibility for any aspects of the internal audit function that are outsourced to a third party.

The audit committee should provide oversight to the internal audit function. Audit committee meetings should be on a frequency that facilitates this oversight and generally should be held four times a year at a minimum, with additional meetings held by audit committees of larger financial institutions. Annually, the audit committee should review and approve internal audit's charter, budget and staffing levels, and the audit plan and overall risk-assessment methodology. The committee approves the CAE's hiring, annual performance evaluation, and compensation.

The audit committee and its chairperson should have ongoing interaction with the CAE separate from formally scheduled meetings to remain current on any internal audit department, organizational, or industry concerns. In addition, the audit committee should have executive sessions with the CAE without members of senior management present as needed.

The audit committee should receive appropriate levels of management information to fulfill its oversight responsibilities. At a minimum, the audit committee should receive the following data with respect to internal audit:

- Audit results with a focus on areas rated less than satisfactory;
- Audit plan completion status and compliance with report issuance timeframes;
- Audit plan changes, including the rationale for significant changes;
- Audit issue information, including aging, past-due status, root-cause analysis, and thematic trends;
- Information on higher-risk issues indicating the potential impact, root cause, and remediation status;
- Results of internal and external quality assurance reviews;
- Information on significant industry and institution trends in risks and controls;
- Reporting of significant changes in audit staffing levels;
- Significant changes in internal audit processes, including a periodic review of key internal audit policies and procedures;
- Budgeted audit hours versus actual audit hours;
- Information on major projects; and
- Opinion on the adequacy of risk-management processes, including effectiveness of management's self-assessment and remediation of identified issues (at least annually).

Role of the chief audit executive. In addition to communicating and reporting to the audit committee on audit-related matters, the CAE is responsible for developing and maintaining a quality assurance and improvement program that covers all aspects of internal audit activity, and for continuously monitoring the effectiveness of the audit function. The CAE and/or senior staff should effectively manage and monitor all aspects of audit work on an ongoing basis, including any audit work that is outsourced.[31]

The Adequacy of the Internal Audit Function's Processes

Internal audit should have an understanding of the institution's strategy and operating processes as well as the potential impact of current market and macroeconomic conditions on the financial institution. Internal audit's risk-assessment methodology is an integral part of the evaluation of overall policies, procedures, and controls at the institution and the development of a plan to test those processes.

Audit methodology. Internal audit should ensure that it has a well-developed risk-assessment methodology that drives its risk-assessment process. The methodology should include an analysis of cross-institutional risk and thematic control issues and address its processes and procedures for evaluating the effectiveness of risk management, control, and governance processes. The methodology should also address the role of continuous monitoring in determining and evaluating risk, as well as internal

31. The ongoing review of audit work should include risk assessments of audit entities and elements, scope documents, audit programs, detailed audit procedures and steps (including sampling methodologies), audit work papers, audit findings, and monitoring of the timely and effective resolution of audit issues.

audit's process for incorporating other risk identification techniques that the institution's management utilizes such as a risk and control self-assessment (RCSA). The components of an effective methodology should support the internal audit function's assessment of the control environment, beginning with an evaluation of the audit universe.

Audit universe. Internal audit should have effective processes to identify all auditable entities within the audit universe. The number of auditable entities will depend upon whether entities are captured at individual department levels or at other aggregated organizational levels. Internal audit should use its knowledge of the institution to determine whether it has identified all auditable entities and may use the general ledger, cost centers, new product approval processes, organization charts, department listings, knowledge of the institution's products and services, major operating and application systems, significant laws and regulations, or other data. The audit universe should be documented and reviewed periodically as significant organizational changes occur or at least during the annual audit planning process.

Internal audit risk assessment. A risk assessment should document the internal audit staff's understanding of the institution's significant business activities and the associated risks. These assessments typically analyze the risks inherent in a given business line or process, the mitigating control processes, and the resulting residual risk exposure to the institution.

A comprehensive risk assessment should effectively analyze the key risks (and the critical risk-management functions) within the institution and prioritize audit entities within the audit universe. The risk-assessment process should be well documented and dynamic, reflecting changes to the system of internal controls, infrastructure, work processes, and new or changed business lines or laws and regulations. The risk assessments should also consider thematic control issues, risk tolerance, and governance within the institution. Risk assessments should be revised in light of changing market conditions or laws and regulations and updated during the year as changes are identified in the business activities of the institution or observed in the markets in which the institution operates, but no less than annually. When the risk assessment indicates a change in risk, the audit plan should be reviewed to determine whether the planned audit coverage should be increased or decreased to address the revised assessment of risk.

Risk assessments should be formally documented and supported with written analysis of the risks.[32] There should be risk assessments for critical risk-management functions within the institution. Risk assessments may be quantitative or qualitative and may include factors such as the date of the last audit, prior audit results, the impact and likelihood of an event occurring, and the status of external vendor relationships. A management RCSA, if performed, may be considered by the internal audit function in developing its independent risk assessment. The internal audit risk assessment should also include a specific rationale for the overall auditable entity risk score. The overall disposition of the risk assessment should be summarized with consideration given to key performance or risk indicators and prior audit results. A high-level summary or discussion of the risk-assessment results should be provided to the audit committee and include the most significant risks facing the institution as well as how these risks have been addressed in the internal audit plan.

Internal audit plan. Internal audit should develop and periodically revise its comprehensive audit plan and ensure that audit coverage for all identified, auditable entities within the audit universe is appropriate for the size and complexity of the institution's activities. This should be accomplished either through a multiyear plan approach, with the plan revised annually, or through an approach that utilizes a framework to evaluate risks annually focusing on the most significant risks. In the latter approach, there should be a mechanism in place to identify when a significant risk will not be audited in the specified timeframe and a requirement to notify the audit committee and seek its approval of any exception to the framework. Generally, common practice for institutions with defined audit cycles is to follow either a three- or four-year audit cycle; high-risk areas should be audited at least every twelve to eighteen months.[33]

32. For example, risks include credit, market, operational, liquidity, compliance, IT, fraud, political, legal, regulatory, strategic, and reputational.

33. Regardless of the institution's practice, particular care should be taken to ensure that higher-risk elements are reviewed with an appropriate frequency, and not obscured due to their inclusion in a lower risk-rated audit entity.

The internal audit plan should consider the risk assessment and internal audit's approach to audit coverage should be appropriate based on the risk assessment. An effective plan covers individual business areas and risk disciplines as well as cross-functional and cross-institutional areas.

The audit planning process should be dynamic, allowing for change when necessary. The process should include a process for modifying the internal audit plan to incorporate significant changes that are identified either through continuous monitoring or during an audit. Any significant changes should be clearly documented and included in quarterly communications to the audit committee. Critical data to be reported to the audit committee should include deferred or cancelled audits rated high-risk and other significant additions or deletions. Significant changes to audit budgets and timeliness for the completion of audits should be reported to the audit committee with documented rationale.

Internal audit continuous monitoring. Internal audit is encouraged to utilize formal continuous monitoring practices as part of the function's risk-assessment processes to support adjustments to the audit plan or universe as they occur. Continuous monitoring can be conducted by an assigned group or individual internal auditors. An effective continuous monitoring process should include written standards to ensure consistent application of processes throughout the organization.

Continuous monitoring results should be documented through a combination of metrics, management reporting, periodic audit summaries, and updated risk assessments to substantiate that the process is operating as designed. Critical issues identified through the monitoring process should be communicated to the audit committee. Computer-assisted auditing techniques are useful tools to highlight issues that warrant further consideration within a continuous monitoring process.

Internal Audit Performance and Monitoring Processes

Performance. Detailed guidance related to the performance of an internal audit should be documented in the audit manual[34] and work programs to ensure that audit execution is consistent across the audit function. Internal audit policies and procedures should be designed to ensure that audits are executed in a high-quality manner, their results are appropriately communicated, and issues are monitored and appropriately resolved. In performing internal audit work, an institution should consider the following.

- *Internal audit scope:* During the audit planning process, internal audit should analyze the auditable entity's specific risks, mitigating controls, and level of residual risk. The information gathered during the audit planning phase should be used to determine the scope and specific audit steps that should be performed to test the adequacy of the design and operating effectiveness of control processes.

- *Internal audit work papers:* Work papers document the work performed, observations and analyses made, and support for the conclusions and audit results. The work papers should contain sufficient information regarding any scope or audit program modifications and waiver of issues not included in the final report. Work papers also should document the specific sampling methodology, including minimum sample sizes, and the rationale for such methodology. The work papers should contain information that reflects all phases of the audit process including planning, fieldwork, reporting, and issues tracking and follow-up. On an ongoing basis, a comprehensive supervisory review should be performed on all audit work, including any outsourced internal audit procedures.[35]

- *Audit report:* Internal audit should have effective processes to ensure that issues are communicated throughout the institution and audit issues are addressed in a timely manner. The audit report should include an executive summary that describes the auditable area, audit's conclusions, the rationale for those conclusions, and key issues. Most audit reports also include management's action plans to address

34. To facilitate effective, efficient, and consistent practice within the internal audit department, an institution should develop an audit manual that includes comprehensive policies and procedures and is made available to all internal audit staff. The manual should be updated as needed.

35. An experienced audit manager should perform this review.

audit findings. To ensure that identified issues are addressed in a timely manner, reports should be issued to affected business areas, senior management, and the audit committee within an appropriate timeframe after the completion of field work. Compliance with issuance timeframes should be monitored and reported periodically to the audit committee. At a minimum, internal audit should ensure that management considers the level and significance of the risk when assigning resources to address and remediate issues. Management should appropriately document the action plans either within the audit report or separately.

- *Internal audit issues tracking:* Internal audit should have effective processes in place to track and monitor open audit issues and to follow-up on such issues. The timely remediation of open audit issues is an essential component of an organization's risk reduction efforts. Internal audit and the responsible management should discuss and agree to an appropriate resolution date, based on the level of work necessary to complete remediation processes. When an issue owner indicates that work to close an issue is completed, the internal audit function should perform validation work prior to closing the issue. The level of validation necessary may vary based on the issue's risk level. For higher-risk issues, internal audit should perform and document substantive testing to validate that the issue has been resolved. Issues should be tested over an appropriate period of time to ensure the sustainability of the remediation.

Retrospective review processes. When an adverse event occurs at an institution (for example, fraud or a significant loss), management should conduct a post-mortem and "lessons learned" analysis. In these situations, internal audit should ensure that such a review takes place and appropriate action is taken to remediate identified issues. The internal audit function should evaluate management's analysis of the reasons for the event and whether the adverse event was the result of a control breakdown or failure, and identify the measures that should be put in place to prevent a similar event from occurring in the future. In certain situations, the internal audit function should conduct its own post-mortem and a "lessons learned" analysis outlining the remediation procedures necessary to detect, correct, and/or prevent future internal control breakdowns (including improvements in internal audit processes).

Quality assurance and improvement program. A well-designed, comprehensive quality assurance program should ensure that internal audit activities conform to the IIA's professional standards and the institution's internal audit policies and procedures. The program should include both internal and external quality assessments.

The internal audit function should develop and document its internal assessment program to promote and assess the quality and consistency of audit work across all audit groups with respect to policies, procedures, audit performance, and work papers. The quality assurance review should be performed by someone independent of the audit work being reviewed. Conclusions reached and recommendations for appropriate improvement in internal audit process or staff training should be implemented by the CAE through the quality assurance and improvement program. Action plan progress should be monitored and subsequently closed after a period of sustainability. Each institution should conduct an internal quality assessment annually and the CAE should report the results and status of internal assessments to senior management and the audit committee at least annually.

The IIA recommends that an external quality assessment of internal audit be performed by a qualified independent party at least once every five years. The review should address compliance with the IIA's definition of internal auditing, code of ethics, and standards, as well as with the internal audit function's charter, policies and procedures, and any applicable legislative and regulatory requirements. The CAE should communicate the results, planned actions, and status of remediation efforts to senior management and the audit committee.

Internal Audit Outsourcing Arrangements *(Part II of the 2003 Policy Statement)*

As stated in the 2003 Policy Statement, an institution's board of directors and senior management are charged with the overall responsibility for maintaining an effective system of internal controls. Responsibility for maintaining an effective system of internal controls cannot be delegated to a third party. An institution that chooses to outsource audit work should ensure that the audit committee maintains ownership of the internal audit function. The institution's audit committee and CAE should provide active and effective oversight of outsourced activities. Institutions should carefully consider the oversight responsibilities that are consequential to these types of arrangements in determining appropriate staffing levels.

To distinguish its duties from those of the outsourcing vendor, the institution should have a written contract, which may take the form of an engagement letter or similar services agreement. Contracts between the institution and the vendor should include a provision stating that work papers and any related non-public confidential information and personal information must be handled by the vendor in accordance with applicable laws and regulations. An institution should periodically confirm that the vendor continues to comply with the agreed-upon confidentiality requirements, especially for long-term contracts. The audit committee should approve all significant aspects of outsourcing arrangements and should receive information on audit deficiencies in a manner consistent with that provided by the in-house audit department.

Vendor Competence

An institution should have appropriate policies and procedures governing the selection and oversight of internal audit vendors, including whether to continue with an existing outsourced arrangement. The audit committee and the CAE are responsible for the selection and retention of internal audit vendors and should be aware of factors that may impact vendors' competence and ability to deliver high-quality audit services.

Contingency Planning

An institution's contingency plan should take into consideration the extent to which the institution relies upon outsourcing arrangements. When an institution relies significantly on the resources of an internal audit service provider, the institution should have contingency procedures for managing temporary or permanent disruptions in the service in order to ensure that the internal audit function can meet its intended objectives.

Quality of Audit Work

The quality of audit work performed by the vendor should be consistent with the institution's standards of work expected to be performed by an in-house internal audit department. Further, information supplied by the vendor should provide the board of directors, its audit committee, and senior management with an accurate report on the control environment, including any changes necessary to enhance controls.

Independence Guidance for the Independent Public Accountant *(Part III of the 2003 Policy Statement)*

The following discussion supplements the discussion in Part III of the 2003 Policy Statement and addresses additional requirements regarding auditor independence for depository institutions subject to section 36 of the FDI Act (as amended in 2009).

Depository Institutions Subject to the Annual Audit and Reporting Requirements of Section 36 of the FDI Act

The July 2009 amendments to section 36 of the FDI Act (applicable to insured depository institutions with total assets of $500 million or more) require an institution's external auditor to follow the more restrictive of the independence rules issued by the AICPA, SEC, and PCAOB. In March 2003, the SEC prohibited a registered public accounting firm that is responsible for furnishing an opinion on the consolidated or separate financial statements of an audit client from providing internal audit services to that same client.[36] Therefore, by following the more restrictive independence rules, a depository institution's external auditor is precluded from performing internal audit services, either on a

36. See SEC final rule, "Strengthening the Commission's Requirements Regarding Auditor Independence," at 17 CFR parts 210, 240, 249 and 274.

co-sourced or an outsourced basis, even if the institution is not a public company.

Examination Guidance *(Part IV of the 2003 Policy Statement)*

The following discussion supplements the existing guidance in Part IV of the 2003 Policy Statement on examination guidance and discusses the overall effectiveness of an institution's internal audit function and the examiner's reliance on internal audit.

Determining the Overall Effectiveness of Internal Audit

An effective internal audit function is a vehicle to advance an institution's safety and soundness and compliance with consumer laws and regulations and is therefore considered as part of the supervisory review process. Federal Reserve examiners will make an overall determination as to whether the internal audit function and its processes are effective or ineffective and whether examiners can potentially rely upon internal audit's work as part of the supervisory review process. If internal audit's overall processes are deemed effective, examiners may be able to rely on the work performed by internal audit depending on the nature and risk of the functions subject to examination.

The supervisory assessment of internal audit and its effectiveness will consider an institution's application of the 2003 Policy Statement and this supplemental guidance. An institution's internal audit function generally would be considered effective if the institution's internal audit function structure and practices are consistent with the 2003 Policy Statement and this guidance.

Conversely, an institution's internal audit function that does not follow the enhanced practices and supplemental guidance outlined in this policy letter generally will be considered ineffective. In such a case, examiners will not rely on the institution's internal audit function.

Examiners will inform the CAE as to whether the function is deemed to be effective or ineffective. Internal audit's overall processes could be deemed effective even though some aspects of the internal audit function may require enhancements or improvements such as additional documentation with respect to specific audit processes (for example, risk assessments or work papers). In these situations, the required enhancements or improvements generally should not be a critical part of the overall internal audit function, or the function should be deemed to be ineffective.

Relying on the Work Performed by Internal Audit

Examiners may rely on internal audit at supervised institutions if internal audit was deemed effective at the most recent examination of internal audit. In examining an institution's internal audit function, examiners will supplement their examination procedures through continuous monitoring and an assessment of key elements of internal audit, including (1) the adequacy and independence of the audit committee; (2) the independence, professional competence, and quality of the internal audit function; (3) the quality and scope of the audit methodology, audit plan, and risk assessment; and (4) the adequacy of audit programs and work paper standards. On at least an annual basis, examiners should review these key elements to determine whether there have been significant changes in the internal audit infrastructure or whether there are potential concerns regarding their adequacy.

Examiners may choose to rely on the work of internal audit when internal audit's overall function and related processes are effective and when recent work was performed by internal audit in an area where examiners are performing examination procedures. For example, if an internal audit department performs internal audit work in an area where examiners might also review controls, examiners may evaluate whether they can rely on the work of internal audit (and either eliminate or reduce the testing scheduled as part of the regulatory examination processes). In high-risk areas, examiners will consider whether additional examination work is needed even where internal audit has been deemed effective and its work reliable.

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(End of the January 23, 2013, Supplemental Policy Statement)

INDEPENDENCE OF INTERNAL AUDITORS

The ability of the internal audit function to achieve its audit objectives depends, in large part, on the independence maintained by audit personnel. Frequently, the independence of internal auditing can be determined by its reporting lines within the organization and by the person or level to whom these results are reported. In most circumstances, the internal audit function is under the direction of the board of directors or a committee thereof, such as the audit committee. This relationship enables the internal audit function to assist the directors in fulfilling their responsibilities.

The auditor's responsibilities should be addressed in a position description, with reporting lines delineated in personnel policy, and audit results should be documented in audit committee and board of directors' minutes. Examiners should review these documents, as well as the reporting process followed by the auditor, in order to subsequently evaluate the tasks performed by the internal audit function. The internal auditor should be given the authority necessary to perform the job, including free access to any records necessary for the proper conduct of the audit. Furthermore, internal auditors generally should not have responsibility for the accounting system, other aspects of the institution's accounting function, or any operational function not subject to independent review.

Competence of Internal Auditors

The responsibilities and qualifications of internal auditors vary depending on the size and complexity of a bank's operations and on the emphasis placed on the internal audit function by the directorate and management. In many banks, the internal audit function is performed by an individual or group of individuals whose sole responsibility is internal auditing. In other banks, particularly small ones, internal audit may be performed on a part-time basis by an officer or employee.

The qualifications discussed below should not be viewed as minimum requirements but should be considered by the examiner in evaluating the work performed by the internal auditors or audit departments. Examples of the type of qualifications an internal audit department manager should have are—

- academic credentials comparable to other bank officers who have major responsibilities within the organization,
- commitment to a program of continuing education and professional development,
- audit experience and organizational and technical skills commensurate with the responsibilities assigned, and
- oral and written communication skills.

The internal audit department manager must be properly trained to fully understand the flow of data and the underlying operating procedures. Training may come from college courses, courses sponsored by industry groups such as the Bank Administration Institute (BAI), or in-house training programs. Significant work experience in various departments of a bank also may provide adequate training. Certification as a chartered bank auditor, certified internal auditor, or certified public accountant meets educational and other professional requirements. In addition to prior education, the internal auditor should be committed to a program of continuing education, which may include attending technical meetings and seminars and reviewing current literature on auditing and banking.

The internal auditor's organizational skills should be reflected in the effectiveness of the bank's audit program. Technical skills may be demonstrated through internal audit techniques, such as internal control and other questionnaires, and an understanding of the operational and financial aspects of the organization.

In considering the competence of the internal audit staff, the examiner should review the educational and experience qualifications required by the bank for filling the positions in the internal audit department and the training available for that position. In addition, the examiner must be assured that any internal audit supervisor understands the audit objectives and procedures performed by the staff.

In a small bank, it is not uncommon to find that internal audit, whether full- or part-time, is a one-person department. The internal auditor may plan and perform all procedures personally or may direct staff borrowed from other departments. In either case, the examiner should expect, at a minimum, that the internal auditor possesses qualifications similar to those of an audit department manager, as previously discussed.

The final measure of the competence of the internal auditor is the quality of the work performed, the ability to communicate the results of that work, and the ability to follow up on deficiencies noted during the audit work. Accordingly, the examiner's conclusions with respect to an auditor's competence should also reflect the adequacy of the audit program and the audit reports.

IMPLEMENTATION OF THE INTERNAL AUDIT FUNCTION

The annual audit plan and budgets should be set by the internal audit manager and approved by the board, audit committee, or senior management. In many organizations, the internal audit manager reports to a senior manager for administrative purposes. The senior manager appraises the audit manager's performance, and the directors or an audit committee approves the evaluation.

Risk Assessment

In setting the annual audit plan, a risk assessment should be made that documents the internal audit function's understanding of the institution's various business activities and their inherent risks. In addition, the assessment also evaluates control risk, or the potential that deficiencies in the system of internal control would expose the institution to potential loss. The assessment should be periodically updated to reflect changes in the system of internal control, work processes, business activities, or the business environment. The risk-assessment methodology of the internal audit function should identify all auditable areas, give a detailed basis for the auditors' determination of relative risks, and be consistent from one audit area to another. The risk assessment can quantify certain risks, such as credit risk, market risk, and legal risk. It can also include qualitative aspects, such as the timeliness of the last audit and the quality of management. Although there is no standard approach to making a risk assessment, it should be appropriate to the size and complexity of the institution. While smaller institutions may not have elaborate risk-assessment systems, some analysis should still be available to explain why certain areas are more frequently audited than others.

Within the risk assessment, institutions should clearly identify auditable units along business activities or product lines, depending on how the institution is managed. There should be evidence that the internal audit manager is regularly notified of new products, departmental changes, and new general ledger accounts, all of which should be factored into the audit schedule. Ratings of particular business activities or corporate functions may change with time as the internal audit function revises its method for assessing risk. These changes should be incremental. Large-scale changes in the priority of audits should trigger an investigation into the reasonableness of changes to the risk-assessment methodology.

Audit Plan

The audit plan is based on the risk assessment. The plan should include a summary of key internal controls within each significant business activity, the timing and frequency of planned internal audit work, and a resource budget.

A formal, annual audit plan should be developed based on internal audit's risk assessment. The audit plan should include all auditable areas and set priorities based on the rating determined by the risk assessment. The schedule of planned audits should be approved by the board or its audit committee, as should any subsequent changes to the plan. Many organizations develop an audit plan jointly with the external auditors. In this case, the audit plan should clearly indicate what work is being performed by internal and external auditors and what aspects of internal audit work the external auditors are relying on.

Typically, the schedule of audit is cyclic; for example, high risks are audited annually, moderate risks every two years, and low risks every three years. In some cases, the audit cycle may extend beyond three years. In reviewing the annual plan, examiners should determine the appropriateness of the institution's audit cycle. Some institutions limit audit coverage of their low-risk areas. Examiners should review areas the institution has labeled "low risk" to determine if the classification is appropriate and if coverage is adequate.

Audit Manual

The internal audit department should have an audit manual that sets forth the standards of work for field auditors and audit managers to use in their assignments. A typical audit manual contains the audit unit's charter and mission, administrative procedures, workpaper-documentation standards, reporting standards, and review procedures. Individual audits should conform to the requirements of the audit manual. As a consequence, the manual should be up-to-date with respect to the audit function's mission and changes to the professional standards it follows.

Performance of Individual Audits

The internal audit manager should oversee the staff assigned to perform the internal audit work and should establish policies and procedures to guide them. The internal audit function should be competently supervised and staffed by people with sufficient expertise and resources to identify the risks inherent in the institution's operations and to assess whether internal controls are effective. While audits vary according to the objective, the area subjected to audit, the standards used as the basis for work performed, and documentation, the audit process generates some common documentation elements, as described below.

Audit Program and Related Workpapers

The audit program documents the audit's objectives and the procedures that were performed. Typically, it indicates who performed the work and who has reviewed it. Workpapers document the evidence gathered and conclusions drawn by the auditor, as well as the disposition of audit findings. The workpapers should provide evidence that the audit program adheres to the requirements specified in the audit manual.

Audit Reports

The audit report is internal audit's formal notice of its assessment of internal controls in the audited areas. The report is given to the area's managers, senior management, and directors. A typical audit report states the purpose of the audit and its scope, conclusions, and recommendations. Reports are usually prepared for each audit. In larger institutions, monthly or quarterly summaries that highlight major audit issues are prepared for senior management and the board.

EXAMINER REVIEW OF INTERNAL AUDIT

The examination procedures section describes the steps the examiner should follow when conducting a review of the work performed by the internal auditor. The examiner's review and evaluation of the internal audit function is a key element in determining the scope of the examination. In most situations, the competence and independence of the internal auditors may be reviewed on an overall basis; however, the adequacy and effectiveness of the audit program should be determined separately for each examination area.

The examiner should assess if the work performed by the internal auditor is reliable. It is often more efficient for the examiner to determine the independence or competence of the internal auditor before addressing the adequacy or effectiveness of the audit program. If the examiner concludes that the internal auditor possesses neither the independence nor the competence deemed appropriate, the examiner must also conclude that the internal audit work performed is not reliable.

The examiner should indicate in the report of examination any significant deficiencies concerning the internal audit function. Furthermore, the examiner should review with management any significant deficiencies noted in the previous report of examination to determine if these concerns have been appropriately addressed.

Program Adequacy and Effectiveness

An examiner should consider the following factors when assessing the adequacy of the internal audit program—

- scope and frequency of the work performed,
- content of the programs,
- documentation of the work performed, and
- conclusions reached and reports issued.

The scope of the internal audit program must be sufficient to attain the audit objectives. The frequency of the audit procedures performed should be based on an evaluation of the risk associated with each targeted area under audit. Among the factors that the internal auditor should consider in assessing risk are the nature of the operation of the specific assets and liabilities under review, the existence of appropriate policies and internal control standards, the effectiveness of operating procedures and internal controls, and the potential materiality of errors or irregularities associated with the specific operation.

To further assess the adequacy and effectiveness of the internal audit program, an examiner needs to obtain audit workpapers. Workpapers should contain, among other things, audit work programs and analyses that clearly indicate the procedures performed, the extent of the testing, and the basis for the conclusions reached.

Although audit work programs are an integral part of the workpapers, they are sufficiently important to deserve separate attention. Work programs serve as the primary guide to the audit procedures to be performed. Each program should provide a clear, concise description of the work required, and individual procedures should be presented logically. The detailed procedures included in the program vary depending on the size and complexity of the bank's operations and the area subject to audit. In addition, an individual audit work program may encompass several departments of the bank, a single department, or specific operations within a department. Most audit programs include procedures such as—

- surprise examinations, where appropriate;
- maintenance of control over records selected for audit;
- review and evaluation of the bank's policies and procedures and the system of internal control;
- reconciliation of detail to related control records; and
- verification of selected transactions and balances through procedures such as examination of supporting documentation, direct confirmation and appropriate follow-up of exceptions, and physical inspection.

The internal auditor should follow the specific procedures included in all work programs to reach audit conclusions that will satisfy the related audit objectives. Audit conclusions should be supported by report findings; such reports should include, when appropriate, recommendations by the internal auditor for any required remedial actions.

The examiner should also analyze the internal reporting process for the internal auditor's findings, since required changes in the bank's internal controls and operating procedures can be made only if appropriate officials are informed of the deficiencies. This means that the auditor must communicate all findings and recommendations clearly and concisely, pinpointing problems and suggesting solutions. The auditor also should submit reports as soon as practical, and the reports should be routed to those authorized to implement the suggested changes.

The final measure of the effectiveness of the audit program is a prompt and effective management response to the auditor's recommendations. The audit department should determine the reasonableness, timeliness, and completeness of management's response to their recommendations, including follow-up, if necessary. Examiners should assess management's response and follow up when the response is either incomplete or unreasonable.

EXTERNAL AUDITS

The Federal Reserve requires bank holding companies with total consolidated assets of $500 million or more to have annual independent audits. Generally, banks must have external audits for the first three years after obtaining FDIC insurance (an FDIC requirement) and upon becoming a newly chartered national bank (an OCC requirement). The SEC also has a longstanding audit requirement for all public companies, which applies to bank holding companies that are SEC registrants and to state member banks that are subject to SEC reporting requirements pursuant to the Federal Reserve's Regulation H.

For insured depository institutions with fiscal years beginning after December 31, 1992, FDICIA, through its amendments to section 36 of the FDI Act, requires annual independent audits for all FDIC-insured banks that have total assets in excess of $500 million. (See SR-94-3 and SR-96-4.) In September 1999, the Federal Financial Institutions Examination Council (FFIEC) issued an interagency policy statement on external auditing programs of banks and savings associations.[37] The policy encourages banks and savings associations that have *less than* $500 million in total assets and that are not subject to other audit requirements to adopt an external auditing program as a part of their overall risk-management process. (See the following subsection for the complete text of the interagency policy statement.)

Independent audits enhance the probability that financial statements and reports to the FRB and other financial-statement users will be accurate and will help detect conditions that could adversely affect banking organizations, the FRB, or the public. The independent audit process also subjects the internal controls and the accounting policies, procedures, and records of each banking organization to periodic review.

Banks often employ external auditors and other specialists to assist management in specialized fields, such as taxation and management information systems. External auditors and consultants often conduct in-depth reviews of the operations of specific bank departments; the reviews might focus on operational procedures, personnel requirements, or other specific areas of interest. After completing the reviews, the auditors may recommend that the bank strengthen controls or improve efficiency.

External auditors provide services at various times during the year. Financial statements are examined annually. Generally, the process commences in the latter part of the year, with the report issued as soon thereafter as possible. Other types of examinations or reviews are performed at various dates on an as-required basis.

The examiner is interested in the work performed by external auditors for three principal reasons. First, situations will arise when internal audit work is not being performed or when such work is deemed to be of limited value to the examiner. Second, the work performed by external auditors may affect the amount of testing the examiner must perform. Third, external audit reports often provide the examiner with information pertinent to the examination of the bank.

The major factors that should be considered in evaluating the work of external auditors are similar to those applicable to internal auditors, namely, the competence and independence of the auditors and the adequacy of the audit program.

The federal banking agencies view a full-scope annual audit of a bank's financial statements by an independent public accountant as preferable to other types of external auditing programs. The September 1999 policy statement recognizes that a full-scope audit may not be feasible for every small bank. It therefore encourages those banks to pursue appropriate alternatives to a full-scope audit. Small banks are also encouraged to establish an audit committee consisting of outside directors. The policy statement provides guidance to examiners on the review of external auditing programs.

The policy statement is consistent with the Federal Reserve's longstanding guidance that encourages the use of external auditing programs, and with its goals for (1) ensuring the accuracy and reliability of regulatory reports, (2) improving the quality of bank internal controls over financial reporting, and (3) enhancing the efficiency of the risk-focused examination process. The Federal Reserve adopted the FFIEC policy statement effective for fiscal years beginning on or after January 1, 2000. (See SR-99-33.)

INTERAGENCY POLICY STATEMENT ON EXTERNAL AUDITING PROGRAMS OF BANKS AND SAVINGS ASSOCIATIONS

Introduction

The board of directors and senior managers of a banking institution or savings association (institution) are responsible for ensuring that the institution operates in a safe and sound manner. To achieve this goal and meet the safety-and-soundness guidelines implementing section 39 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831p-1),[38] the institution should maintain effective systems and internal control[39] to produce reliable and accurate financial reports.

37. See 64 *Fed. Reg.* 52319 (September 28, 1999).

38. See 12 CFR 30 for national banks; 12 CFR 364 for state nonmember banks; 12 CFR 208 for state member banks; and 12 CFR 510 for savings associations.

39. This policy statement provides guidance consistent

Accurate financial reporting is essential to an institution's safety and soundness for numerous reasons. First, accurate financial information enables management to effectively manage the institution's risks and make sound business decisions. In addition, institutions are required by law[40] to provide accurate and timely financial reports (e.g., Reports of Condition and Income [call reports] and Thrift Financial Reports) to their appropriate regulatory agency. These reports serve an important role in the agencies'[41] risk-focused supervision programs by contributing to their pre-examination planning, off-site monitoring programs, and assessments of an institution's capital adequacy and financial strength. Further, reliable financial reports are necessary for the institution to raise capital. They provide data to stockholders, depositors and other funds providers, borrowers, and potential investors on the company's financial position and results of operations. Such information is critical to effective market discipline of the institution.

To help ensure accurate and reliable financial reporting, the agencies recommend that the board of directors of each institution establish and maintain an external auditing program. An external auditing program should be an important component of an institution's overall risk-management process. For example, an external auditing program complements the internal auditing function of an institution by providing management and the board of directors with an independent and objective view of the reliability of the institution's financial statements and the adequacy of its financial-reporting internal controls. Additionally, an effective external auditing program contributes to the efficiency of the agencies' risk-focused examination process. By considering the significant risk areas of an institution, an effective external auditing program may reduce the examination time the agencies spend in such areas. Moreover, it can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the Federal Deposit Insurance Corporation (FDIC).

This policy statement outlines the characteristics of an effective external auditing program and provides examples of how an institution can use an external auditor to help ensure the reliability of its financial reports. It also provides guidance on how an examiner may assess an institution's external auditing program. In addition, this policy statement provides specific guidance on external auditing programs for institutions that are holding company subsidiaries, newly insured institutions, and institutions presenting supervisory concerns.

The adoption of a financial statement audit or other specified type of external auditing program is generally only required in specific circumstances. For example, insured depository institutions covered by section 36 of the FDI Act (12 USC 1831m), as implemented by part 363 of the FDIC's regulations (12 CFR 363), are required to have an external audit and an audit committee. Therefore, this policy statement is directed toward banks and savings associations which are exempt from part 363 (i.e., institutions with less than $500 million in total assets at the beginning of their fiscal year) or are not otherwise subject to audit requirements by order, agreement, statute, or agency regulations.

Overview of External Auditing Programs

Responsibilities of the Board of Directors

The board of directors of an institution is responsible for determining how to best obtain reasonable assurance that the institution's financial statements and regulatory reports are reliably prepared. In this regard, the board is also responsible for ensuring that its external auditing program is appropriate for the institution and adequately addresses the financial-reporting aspects of the significant risk areas and any other areas of concern of the institution's business.

To help ensure the adequacy of its internal and external auditing programs, the agencies encourage the board of directors of each institution that is not otherwise required to do so to establish an audit committee consisting entirely of outside directors.[42] However, if this is impracticable, the board should organize the

with the guidance established in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

40. See 12 USC 161 for national banks; 12 USC 1817a for state nonmember banks; 12 USC 324 for state member banks; and 12 USC 1464(v) for savings associations.

41. Terms are defined at the end of the policy statement.

42. Institutions with $500 million or more in total assets must establish an independent audit committee made up of outside directors who are independent of management. See 12 USC 1831m(g)(1) and 12 CFR 363.5.

audit committee so that outside directors constitute a majority of the membership.

Audit Committee

The audit committee or board of directors is responsible for identifying at least annually the risk areas of the institution's activities and assessing the extent of external auditing involvement needed over each area. The audit committee or board is then responsible for determining what type of external auditing program will best meet the institution's needs (see the descriptions under "Types of External Auditing Programs").

When evaluating the institution's external auditing needs, the board or audit committee should consider the size of the institution and the nature, scope, and complexity of its operations. It should also consider the potential benefits of an audit of the institution's financial statements or an examination of the institution's internal control structure over financial reporting, or both. In addition, the board or audit committee may determine that additional or specific external auditing procedures are warranted for a particular year or several years to cover areas of particularly high risk or special concern. The reasons supporting these decisions should be recorded in the committee's or board's minutes.

If, in its annual consideration of the institution's external auditing program, the board or audit committee determines, after considering its inherent limitations, that an agreed-upon procedures/state-required examination is sufficient, they should also consider whether an independent public accountant should perform the work. When an independent public accountant performs auditing and attestation services, the accountant must conduct his or her work under, and may be held accountable for departures from, professional standards. Furthermore, when the external auditing program includes an audit of the financial statements, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial statements are presented fairly, in all material respects, in accordance with generally accepted accounting principles (GAAP). When the external auditing program includes an examination of the internal control structure over financial reporting, the board or audit committee obtains an opinion from the independent public accountant stating whether the financial-reporting process is subject to any material weaknesses.

Both the staff performing an internal audit function and the independent public accountant or other external auditor should have unrestricted access to the board or audit committee without the need for any prior management knowledge or approval. Other duties of an audit committee may include reviewing the independence of the external auditor annually, consulting with management, seeking an opinion on an accounting issue, and overseeing the quarterly regulatory reporting process. The audit committee should report its findings periodically to the full board of directors.

External Auditing Programs

Basic Attributes

External auditing programs should provide the board of directors with information about the institution's financial-reporting risk areas, e.g., the institution's internal control over financial reporting, the accuracy of its recording of transactions, and the completeness of its financial reports prepared in accordance with GAAP.

The board or audit committee of each institution at least annually should review the risks inherent in its particular activities to determine the scope of its external auditing program. For most institutions, the lending and investment-securities activities present the most significant risks that affect financial reporting. Thus, external auditing programs should include specific procedures designed to test at least annually the risks associated with the loan and investment portfolios. This includes testing of internal control over financial reporting, such as management's process to determine the adequacy of the allowance for loan and lease losses and whether this process is based on a comprehensive, adequately documented, and consistently applied analysis of the institution's loan and lease portfolio.

An institution or its subsidiaries may have other significant financial-reporting risk areas such as material real estate investments, insurance underwriting or sales activities, securities broker-dealer or similar activities (including securities underwriting and investment advisory services), loan-servicing activities, or fiduciary activities. The external auditing program should address these and other activities the board or audit committee determines present significant financial-reporting risks to the institution.

Types of External Auditing Programs

The agencies consider an annual audit of an institution's financial statements performed by an independent public accountant to be the preferred type of external auditing program. The agencies also consider an annual examination of the effectiveness of the internal control structure over financial reporting or an audit of an institution's balance sheet, both performed by an independent public accountant, to be acceptable alternative external auditing programs. However, the agencies recognize that some institutions only have agreed-upon procedures/state-required examinations performed annually as their external auditing program. Regardless of the option chosen, the board or audit committee should agree in advance with the external auditor on the objectives and scope of the external auditing program.

Financial statement audit by an independent public accountant. The agencies encourage all institutions to have an external audit performed in accordance with generally accepted auditing standards (GAAS). The audit's scope should be sufficient to enable the auditor to express an opinion on the institution's financial statements taken as a whole.

A financial statement audit provides assurance about the fair presentation of an institution's financial statements. In addition, an audit may provide recommendations for management in carrying out its control responsibilities. For example, an audit may provide management with guidance on establishing or improving accounting and operating policies and recommendations on internal control (including internal auditing programs) necessary to ensure the fair presentation of the financial statements.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Another external auditing program is an independent public accountant's examination and report on management's assertion on the effectiveness of the institution's internal control over financial reporting. For a smaller institution with less complex operations, this type of engagement is likely to be less costly than an audit of its financial statements or its balance sheet. It would specifically provide recommendations for improving internal control, including suggestions for compensating controls, to mitigate the risks due to staffing and resource limitations.

Such an attestation engagement may be performed for all internal controls relating to the preparation of annual financial statements or specified schedules of the institution's regulatory reports.[43] This type of engagement is performed under generally accepted standards for attestation engagements (GASAE).[44]

Balance-sheet audit performed by an independent public accountant. With this program, the institution engages an independent public accountant to examine and report only on the balance sheet. As with the audit of the financial statements, this audit is performed in accordance with GAAS. The cost of a balance-sheet audit is likely to be less than a financial-statement audit. However, under this type of program, the accountant does not examine or report on the fairness of the presentation of the

43. Since the lending and investment-securities activities generally present the most significant risks that affect an institution's financial reporting, management's assertion and the accountant's attestation generally should cover those regulatory report schedules. If the institution has trading or off-balance-sheet activities that present material financial-reporting risks, the board or audit committee should ensure that the regulatory report schedules for those activities also are covered by management's assertion and the accountant's attestation. For banks and savings associations, the lending, investment-securities, trading, and off-balance-sheet schedules consist of:

Area	*Reports of Condition and Income Schedules*	*Thrift Financial Report Schedules*
Loans and lease-financing receivables	RC-C, Part I	SC, CF
Past-due and nonaccrual loans, leases, and other assets	RC-N	PD
Allowance for credit losses	RI-B	SC, VA
Securities	RC-B	SC, SI, CF
Trading assets and liabilities	RC-D	SO, SI
Off-balance-sheet items	RC-L	SI, CMR

These schedules are not intended to address all possible risks in an institution.

44. An attestation engagement is not an audit. It is performed under different professional standards than an audit of an institution's financial statements or its balance sheet.

institution's income statement, statement of changes in equity capital, or statement of cash flows.

Agreed-upon procedures/state-required examinations. Some state-chartered depository institutions are required by state statute or regulation to have specified procedures performed annually by their directors or independent persons.[45] The bylaws of many national banks also require that some specified procedures be performed annually by directors or others, including internal or independent persons. Depending upon the scope of the engagement, the cost of agreed-upon procedures or a state-required examination may be less than the cost of an audit. However, under this type of program, the independent auditor does not report on the fairness of the institution's financial statements or attest to the effectiveness of the internal control structure over financial reporting. The findings or results of the procedures are usually presented to the board or the audit committee so that they may draw their own conclusions about the quality of the financial reporting or the sufficiency of internal control.

When choosing this type of external auditing program, the board or audit committee is responsible for determining whether these procedures meet the external auditing needs of the institution, considering its size and the nature, scope, and complexity of its business activities. For example, if an institution's external auditing program consists solely of confirmations of deposits and loans, the board or committee should consider expanding the scope of the auditing work performed to include additional procedures to test the institution's high-risk areas. Moreover, a financial statement audit, an examination of the effectiveness of the internal control structure over financial reporting, and a balance-sheet audit may be accepted in some states and for national banks in lieu of agreed-upon procedures/state-required examinations.

Other Considerations

Timing. The preferable time to schedule the performance of an external auditing program is as of an institution's fiscal year-end. However, a quarter-end date that coincides with a regulatory report date provides similar benefits. Such an approach allows the institution to incorporate the results of the external auditing program into its regulatory reporting process and, if appropriate, amend the regulatory reports.

External auditing staff. The agencies encourage an institution to engage an independent public accountant to perform its external auditing program. An independent public accountant provides a nationally recognized standard of knowledge and objectivity by performing engagements under GAAS or GASAE. The firm or independent person selected to conduct an external auditing program and the staff carrying out the work should have experience with financial-institution accounting and auditing or similar expertise and should be knowledgeable about relevant laws and regulations.

Special Situations

Holding Company Subsidiaries

When an institution is owned by another entity (such as a holding company), it may be appropriate to address the scope of its external audit program in terms of the institution's relationship to the consolidated group. In such cases, if the group's consolidated financial statements for the same year are audited, the agencies generally would not expect the subsidiary of a holding company to obtain a separate audit of its financial statements. Nevertheless, the board of directors or audit committee of the subsidiary may determine that its activities involve significant risks to the subsidiary that are not within the procedural scope of the audit of the financial statements of the consolidated entity. For example, the risks arising from the subsidiary's activities may be immaterial to the financial statements of the consolidated entity, but material to the subsidiary. Under such circumstances, the audit committee or board of the subsidiary should consider strengthening the internal audit coverage of those activities or implementing an appropriate alternative external auditing program.

45. When performed by an independent public accountant, "specified procedures" and "agreed-upon procedures" engagements are performed under standards, which are different professional standards than those used for an audit of an institution's financial statements or its balance sheet.

Newly Insured Institutions

Under the FDIC statement of policy on applications for deposit insurance, applicants for deposit insurance coverage are expected to commit the depository institution to obtain annual audits by an independent public accountant once it begins operations as an insured institution and for a limited period thereafter.

Institutions Presenting Supervisory Concerns

As previously noted, an external auditing program complements the agencies' supervisory process and the institution's internal auditing program by identifying or further clarifying issues of potential concern or exposure. An external auditing program also can greatly assist management in taking corrective action, particularly when weaknesses are detected in internal control or management information systems affecting financial reporting.

The agencies may require a financial institution presenting safety-and-soundness concerns to engage an independent public accountant or other independent external auditor to perform external auditing services.[46] Supervisory concerns may include—

- inadequate internal control, including the internal auditing program;
- a board of directors generally uninformed about internal control;
- evidence of insider abuse;
- known or suspected defalcations;
- known or suspected criminal activity;
- probable director liability for losses;
- the need for direct verification of loans or deposits;
- questionable transactions with affiliates; or
- the need for improvements in the external auditing program.

The agencies may also require that the institution provide its appropriate supervisory office with a copy of any reports, including management letters, issued by the independent public accountant or other external auditor. They also may require the institution to notify the supervisory office prior to any meeting with the independent public accountant or other external auditor at which auditing findings are to be presented.

46. The Office of Thrift Supervision requires an external audit by an independent public accountant for savings associations with a composite rating of 3, 4, or 5 under the Uniform Financial Institution Rating System, and on a case-by-case basis.

Examiner Guidance

Review of the External Auditing Program

The review of an institution's external auditing program is a normal part of the agencies' examination procedures. An examiner's evaluation of, and any recommendations for improvements in, an institution's external auditing program will consider the institution's size; the nature, scope, and complexity of its business activities; its risk profile; any actions taken or planned by it to minimize or eliminate identified weaknesses; the extent of its internal audit program; and any compensating controls in place. Examiners will exercise judgment and discretion in evaluating the adequacy of an institution's external auditing program.

Specifically, examiners will consider the policies, processes, and personnel surrounding an institution's external auditing program in determining whether—

- the board of directors or its audit committee adequately reviews and approves external auditing program policies at least annually;
- the external auditing program is conducted by an independent public accountant or other independent auditor and is appropriate for the institution;
- the engagement letter covering external auditing activities is adequate;
- the report prepared by the auditor on the results of the external auditing program adequately explains the auditor's findings;
- the external auditor maintains appropriate independence regarding relationships with the institution under relevant professional standards;
- the board of directors performs due diligence on the relevant experience and competence of the independent auditor and staff carrying out the work (whether or not an independent public accountant is engaged); and
- the board or audit committee minutes reflect approval and monitoring of the external auditing program and schedule, including board or

committee reviews of audit reports with management and timely action on audit findings and recommendations.

Access to Reports

Management should provide the independent public accountant or other auditor with access to all examination reports and written communication between the institution and the agencies or state bank supervisor since the last external auditing activity. Management also should provide the accountant with access to any supervisory memoranda of understanding, written agreements, administrative orders, reports of action initiated or taken by a federal or state banking agency under section 8 of the FDI Act (or a similar state law), and proposed or ordered assessments of civil money penalties against the institution or an institution-related party, as well as any associated correspondence. The auditor must maintain the confidentiality of examination reports and other confidential supervisory information.

In addition, the independent public accountant or other auditor of an institution should agree in the engagement letter to grant examiners access to all the accountant's or auditor's workpapers and other material pertaining to the institution prepared in the course of performing the completed external auditing program.

Institutions should provide reports[47] issued by the independent public accountant or other auditor pertaining to the external auditing program, including any management letters, to the agencies and any state authority in accordance with their appropriate supervisory office's guidance.[48] Significant developments regarding the external auditing program should be communicated promptly to the appropriate supervisory office. Examples of those developments include the hiring of an independent public accountant or other third party to perform external auditing work and a change in, or termination of, an independent public accountant or other external auditor.

Definitions

Agencies. The agencies are the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

Appropriate supervisory office. The regional or district office of the institution's primary federal banking agency responsible for supervising the institution or, in the case of an institution that is part of a group of related insured institutions, the regional or district office of the institution's federal banking agency responsible for monitoring the group. If the institution is a subsidiary of a holding company, the term "appropriate supervisory office" also includes the federal banking agency responsible for supervising the holding company. In addition, if the institution is state-chartered, the term "appropriate supervisory office" includes the appropriate state bank or savings association regulatory authority.

Audit. An examination of the financial statements, accounting records, and other supporting evidence of an institution performed by an independent certified or licensed public accountant in accordance with generally accepted auditing standards (GAAS) and of sufficient scope to enable the independent public accountant to express an opinion on the institution's financial statements as to their presentation in accordance with generally accepted accounting principles (GAAP).

Audit committee. A committee of the board of directors whose members should, to the extent possible, be knowledgeable about accounting and auditing. The committee should be responsible for reviewing and approving the institution's internal and external auditing programs or

47. The institution's engagement letter is not a "report" and is not expected to be submitted to the appropriate supervisory office unless specifically requested by that office.

48. When an institution's financial information is included in the audited consolidated financial statements of its parent company, the institution should provide a copy of the audited financial statements of the consolidated company and any other reports by the independent public accountant in accordance with their appropriate supervisory office's guidance. If several institutions are owned by one parent company, a single copy of the reports may be supplied in accordance with the guidance of the appropriate supervisory office of each agency supervising one or more of the affiliated institutions and the holding company. A transmittal letter should identify the institutions covered. Any notifications of changes in, or terminations of, a consolidated company's independent public accountant may be similarly supplied to the appropriate supervisory office of each supervising agency.

recommending adoption of these programs to the full board.

Balance-sheet audit performed by an independent public accountant. An examination of an institution's balance sheet and any accompanying footnotes performed and reported on by an independent public accountant in accordance with GAAS and of sufficient scope to enable the independent public accountant to express an opinion on the fairness of the balance-sheet presentation in accordance with GAAP.

Engagement letter. A letter from an independent public accountant to the board of directors or audit committee of an institution that usually addresses the purpose and scope of the external auditing work to be performed, period of time to be covered by the auditing work, reports expected to be rendered, and any limitations placed on the scope of the auditing work.

Examination of the internal control structure over financial reporting. See "Reporting by an independent public accountant on an institution's internal control structure over financial reporting."

External auditing program. The performance of procedures to test and evaluate high-risk areas of an institution's business by an independent auditor, who may or may not be a public accountant, sufficient for the auditor to be able to express an opinion on the financial statements or to report on the results of the procedures performed.

Financial statement audit by an independent public accountant. See Audit.

Financial statements. The statements of financial position (balance sheet), income, cash flows, and changes in equity together with related notes.

Independent public accountant. An accountant who is independent of the institution and registered or licensed to practice, and holds himself or herself out, as a public accountant, and who is in good standing under the laws of the state or other political subdivision of the United States in which the home office of the institution is located. The independent public accountant should comply with the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct and any related guidance adopted by the Independence Standards Board and the agencies. No certified public accountant or public accountant will be recognized as independent who is not independent both in fact and in appearance.

Internal auditing. An independent assessment function established within an institution to examine and evaluate its system of internal control and the efficiency with which the various units of the institution are carrying out their assigned tasks. The objective of internal auditing is to assist the management and directors of the institution in the effective discharge of their responsibilities. To this end, internal auditing furnishes management with analyses, evaluations, recommendations, counsel, and information concerning the activities reviewed.

Outside directors. Members of an institution's board of directors who are not officers, employees, or principal stockholders of the institution, its subsidiaries, or its affiliates, and who do not have any material business dealings with the institution, its subsidiaries, or its affiliates.

Regulatory reports. These reports are the Reports of Condition and Income (call reports) for banks, Thrift Financial Reports (TFRs) for savings associations, Federal Reserve (FR) Y reports for bank holding companies, and the H-(b)11 Annual Report for thrift holding companies.

Reporting by an independent public accountant on an institution's internal control structure over financial reporting. Under this engagement, management evaluates and documents its review of the effectiveness of the institution's internal control over financial reporting in the identified risk areas as of a specific report date. Management prepares a written assertion, which specifies the criteria on which management based its evaluation about the effectiveness of the institution's internal control over financial reporting in the identified risk areas and states management's opinion on the effectiveness of internal control over this specified financial reporting. The independent public accountant is engaged to perform tests on the internal control over the specified financial reporting in order to attest to management's assertion. If the accountant concurs with management's assertion, even if the assertion discloses one or more instances of material internal control weakness, the accountant would provide a report attesting to management's assertion.

Risk areas. Those particular activities of an institution that expose it to greater potential losses if problems exist and go undetected. The areas with the highest financial-reporting risk in most institutions generally are their lending and investment-securities activities.

Specified procedures. Procedures agreed upon by the institution and the auditor to test its activities in certain areas. The auditor reports findings and test results, but does not express an opinion on controls or balances. If performed by an independent public accountant, these procedures should be performed under generally accepted standards for attestation engagements (GASAE).

Issued by the FFIEC on September 28, 1999.

UNSAFE AND UNSOUND USE OF LIMITATION OF LIABILITY PROVISIONS IN EXTERNAL AUDIT ENGAGEMENT LETTERS

On February 9, 2006, the Federal Reserve and the other financial institution regulatory agencies (the agencies)[49] issued an interagency advisory (the advisory) to address safety-and-soundness concerns that may arise when financial institutions enter into external audit contracts (typically referred to as *engagement letters*) that limit the auditors' liability for audit services.[50] The advisory informs financial institutions'[51] boards of directors, audit committees, management, and external auditors of the safety-and-soundness implications that may arise when the financial institution enters into engagement letters that contain provisions to limit the auditors' liability. Such provisions may weaken the external auditors' objectivity, impartiality, and performance and, thus, reduce the agencies' ability to rely on audits. Therefore, certain limitation-of-liability provisions (described in the advisory) are unsafe and unsound. In addition, such provisions may not be consistent with the auditor-independence standards of the SEC, the PCAOB, and the AICPA.

The advisory does not apply to previously executed engagement letters. However, any financial institution subject to a multiyear audit engagement letter containing unsafe and unsound limitation-of-liability provisions should seek an amendment to its engagement letter to be consistent with the advisory for periods ending in 2007 or later. (See SR-06-4.)

Scope of the Advisory on Engagement Letters

The advisory applies to engagement letters between financial institutions and external auditors with respect to financial-statement audits, audits of internal control over financial reporting, and attestations on management's assessment of internal control over financial reporting (collectively, *audit* or *audits*).

The advisory does not apply to—

- nonaudit services that may be performed by financial institutions' external auditors,
- audits of financial institutions' 401(k) plans, pension plans, and other similar audits,
- services performed by accountants who are not engaged to perform financial institutions' audits (e.g., outsourced internal audits or loan reviews), and
- other service providers (e.g., software consultants or legal advisers).

While the agencies have observed several types of limitation-of-liability provisions in external audit engagement letters, this advisory applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to audits in an unsafe and unsound manner.

External Audits and Their Engagement Letters

A properly conducted audit provides an independent and objective view of the reliability of a financial institution's financial statements. The

49. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

50. The advisory is effective for audit engagement letters issued on or after February 9, 2006.

51. As used in this advisory, the term *financial institutions* includes banks, bank holding companies, savings associations, savings and loan holding companies, and credit unions.

external auditor's objective in an audit is to form an opinion on the financial statements taken as a whole. When planning and performing the audit, the external auditor considers the financial institution's internal control over financial reporting. Generally, the external auditor communicates any identified deficiencies in internal control to management, which enables management to take appropriate corrective action. In addition, certain financial institutions are required to file audited financial statements and internal control audit or attestation reports with one or more of the agencies. The agencies encourage financial institutions not subject to mandatory audit requirements to voluntarily obtain audits of their financial statements. The FFIEC's *Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations* notes,[52] "[a]n institution's internal and external audit programs are critical to its safety and soundness." The policy also states that an effective external auditing program "can improve the safety and soundness of an institution substantially and lessen the risk the institution poses to the insurance funds administered by the FDIC."

Typically, a written engagement letter is used to establish an understanding between the external auditor and the financial institution regarding the services to be performed in connection with the financial institution's audit. The engagement letter commonly describes the objective of the audit, the reports to be prepared, the responsibilities of management and the external auditor, and other significant arrangements (for example, fees and billing). Boards of directors, audit committees, and management are encouraged to closely review all of the provisions in the audit engagement letter before agreeing to sign. As with all agreements that affect a financial institution's legal rights, the financial institution's legal counsel should carefully review audit engagement letters to help ensure that those charged with engaging the external auditor make a fully informed decision.

The advisory describes the types of objectionable limitation-of-liability provisions and provides examples.[53] Financial institutions' boards of directors, audit committees, and management should also be aware that certain insurance policies (such as error and omission policies and directors' and officers' liability policies) might not cover losses arising from claims that are precluded by limitation-of-liability provisions.

Limitation-of-Liability Provisions

The provisions of an external audit engagement letter that the agencies deem to be unsafe and unsound can be generally categorized as follows: a provision within an agreement between a client financial institution and its external auditor that effectively—

- indemnifies the external auditor against claims made by third parties;
- holds harmless or releases the external auditor from liability for claims or potential claims that might be asserted by the client financial institution, other than claims for punitive damages; or
- limits the remedies available to the client financial institution, other than punitive damages.

Collectively, these categories of provisions are referred to in this advisory as *limitation-of liability-provisions.*

Provisions that waive the right of financial institutions to seek punitive damages from their external auditor are not treated as unsafe and unsound under the advisory. Nevertheless, agreements by clients to indemnify their auditors against any third-party damage awards, including punitive damages, are deemed unsafe and unsound under the advisory. To enhance transparency and market discipline, public financial institutions that agree to waive claims for punitive damages against their external auditors may want to disclose annually the nature of these arrangements in their proxy statements or other public reports.

Many financial institutions are required to have their financial statements audited, while others voluntarily choose to undergo such audits. For example, federally insured banks with $500 million or more in total assets are required

52. See 64 *Fed. Reg.* 52319 (September 28, 1999).

53. In the majority of external audit engagement letters reviewed, the agencies did not observe provisions that limited an external auditor's liability. However, for those reviewed external audit engagement letters that did have external auditor limited-liability provisions, the agencies noted a significant increase in the types and frequency of the provisions. The provisions took many forms, which made it impractical for the agencies to provide an all-inclusive list. Examples of auditor limitation-of-liability provisions are illustrated in the advisory's appendix A, which can be found in section A.1010.1 of this manual.

to have annual independent audits.[54] Furthermore, financial institutions that are public companies[55] must have annual independent audits. The agencies rely on the results of audits as part of their assessment of a financial institution's safety and soundness.

For audits to be effective, the external auditors must be independent in both fact and appearance, and they must perform all necessary procedures to comply with auditing and attestation standards established by either the AICPA or, if applicable, the PCAOB. When financial institutions execute agreements that limit the external auditors' liability, the external auditors' objectivity, impartiality, and performance may be weakened or compromised, and the usefulness of the audits for safety-and-soundness purposes may be diminished.

By their very nature, limitation-of-liability provisions can remove or greatly weaken external auditors' objective and unbiased consideration of problems encountered in audit engagements and may diminish auditors' adherence to the standards of objectivity and impartiality required in the performance of audits. The existence of such provisions in external audit engagement letters may lead to the use of less extensive or less thorough procedures than would otherwise be followed, thereby reducing the reliability of audits. Accordingly, financial institutions should not enter into external audit arrangements that include unsafe and unsound limitation-of-liability provisions identified in the advisory, regardless of (1) the size of the financial institution, (2) whether the financial institution is public or not, or (3) whether the external audit is required or voluntary.

Auditor Independence

Currently, auditor-independence standard-setters include the SEC, PCAOB, and AICPA. Depending on the audit client, an external auditor is subject to the independence standards issued by one or more of these standard-setters. For all nonpublic financial institutions that are not required to have annual independent audits, the FDIC's rules, pursuant to part 363, require only that an external auditor meet the AICPA independence standards. The rules do not require the financial institution's external auditor to comply with the independence standards of the SEC and the PCAOB.

In contrast, for financial institutions subject to the audit requirements in part 363 of the FDIC's regulations, the external auditor should be in compliance with the AICPA's Code of Professional Conduct and meet the independence requirements and interpretations of the SEC and its staff.[56] In this regard, in a December 13, 2004, frequently asked question (FAQ) on the application of the SEC's auditor-independence rules, the SEC staff reiterated its long-standing position that when an accountant and his or her client enter into an agreement that seeks to provide the accountant immunity from liability for his or her own negligent acts, the accountant is not independent. The FAQ also stated that including in engagement letters a clause that would release, indemnify, or hold the auditor harmless from any liability and costs resulting from knowing misrepresentations by management would impair the auditor's independence.[57] The FAQ is consistent with the SEC's Codification of Financial Reporting Policies, section 602.02.f.i , "Indemnification by Client." (See section A.1010.1 of this manual.)

On the basis of the SEC guidance and the agencies' existing regulations, certain limits onauditors' liability are already inappropriate in audit engagement letters entered into by—

- public financial institutions that file reports with the SEC or with the agencies,
- financial institutions subject to part 363, and
- certain other financial institutions that are required to have annual independent audits.

In addition, certain of these limits on auditors' liability may violate the AICPA independence standards. Notwithstanding the potential applicability of auditor-independence standards, the limitation-of-liability provisions discussed in the advisory present safety-and-soundness concerns for all financial institution audits.

54. For banks, see section 36 of the FDI Act (12 USC 1831m) and part 363 of the FDIC's regulations (12 CFR 363).

55. Public companies are companies subject to the reporting requirements of the Securities Exchange Act of 1934.

56. See part 363 of the FDIC's regulation (12 CFR 363), *Appendix A—Guidelines and Interpretations,* Guideline 14, *"Role of the Independent Public Accountant-Independence."*

57. In contrast to the SEC's position, AICPA Ethics Ruling 94 (ET, section 191.188–189) currently concludes that indemnification for "knowing misrepresentations by management" does *not* impair independence.

Alternative Dispute-Resolution Agreements and Jury-Trial Waivers

The agencies observed that a review of the engagement letters of some financial institutions revealed that they had agreed to submit disputes over external audit services to mandatory and binding alternative dispute resolution, binding arbitration, or other binding nonjudicial dispute-resolution processes (collectively, *mandatory ADR*) or to waive the right to a jury trial. By agreeing in advance to submit disputes to mandatory ADR, financial institutions may waive the right to full discovery, limit appellate review, or limit or waive other rights and protections available in ordinary litigation proceedings.

Mandatory ADR procedures and jury-trial waivers may be efficient and cost-effective tools for resolving disputes in some cases. Accordingly, the agencies believe that mandatory ADR or waiver of jury-trial provisions in external audit engagement letters do not present safety-and-soundness concerns, provided that the engagement letters do not also incorporate limitation-of-liability provisions. Institutions are encouraged to carefully review mandatory ADR and jury-trial provisions in engagement letters, as well as review any agreements regarding rules of procedure, and to fully comprehend the ramifications of any agreement to waive any available remedies. Financial institutions should ensure that any mandatory ADR provisions in audit engagement letters are commercially reasonable and—

- apply equally to all parties,
- provide a fair process (for example, neutral decision makers and appropriate hearing procedures), and
- are not imposed in a coercive manner.

The Advisory's Conclusion

Financial institutions' boards of directors, audit committees, and management should not enter into any agreement that incorporates limitation-of-liability provisions with respect to audits. In addition, financial institutions should document their business rationale for agreeing to any other provisions that limit their legal rights.

The inclusion of limitation-of-liability provisions in external audit engagement letters and other agreements that are inconsistent with the advisory will generally be considered an unsafe and unsound practice. Examiners will consider the policies, processes, and personnel surrounding a financial institution's external auditing program in determining whether (1) the engagement letter covering external auditing activities raises any safety-and-soundness concerns and (2) the external auditor maintains appropriate independence regarding relationships with the financial institution under relevant professional standards. The agencies may take appropriate supervisory action if unsafe and unsound limitation-of-liability provisions are included in external audit engagement letters or other agreements related to audits that are executed (accepted or agreed to by the financial institution).

CERTIFIED PUBLIC ACCOUNTANTS

This section discusses the standards for competence and independence of certified public accountants (CPAs) as well as the standards required in connection with their audits.

Standards of Conduct

The Code of Professional Ethics for CPAs who are members of the American Institute of Certified Public Accountants (AICPA) requires that audits be performed according to generally accepted auditing standards (GAAS). GAAS, as distinct from generally accepted accounting principles, or GAAP, are concerned with the auditor's professional qualifications, the judgment the auditor exercises in the performance of an audit, and the quality of the audit procedures.

On the other hand, GAAP represents all of the conventions, rules, and procedures that are necessary to define accepted accounting practices at a particular time. GAAP includes broad guidelines of general application and detailed practices and procedures that have been issued by the Financial Accounting Standards Board (FASB), the AICPA, the SEC, or other authoritative bodies that set accounting standards. Thus, GAAP provides guidance on financial-reporting and disclosure matters.

Generally Accepted Auditing Standards

GAAS are grouped into three categories: general standards, standards of field work, and standards of reporting.

The *general standards* require that the audit be performed by a person or persons having adequate technical training and proficiency; that independence in mental attitude be maintained; and that due professional care be exercised in the performance of the audit and the preparation of the report.

Standards of field work require that the work be adequately planned; assistants, if any, be properly supervised; a proper study and evaluation of existing internal controls be made for determining the audit scope and the audit procedures to be performed during the audit; and sufficient evidence be obtained to formulate an opinion regarding the financial statements under audit.

Standards of reporting require that the CPA state whether the financial statements are presented in accordance with GAAP. The application of GAAP in audited financial statements and reports must achieve the fundamental objectives of financial accounting, which are to provide reliable financial information about the economic resources and obligations of a business enterprise. In addition, the informative disclosures in the financial statements must follow GAAP, or the CPA must state otherwise in the report.

GAAS recognizes that management—not the CPA—has primary responsibility for the preparation of the financial statements and the presentations therein. The auditor's responsibility is to express an opinion on the financial statements. GAAS (or the audit requirements previously set forth) require that audits cover the following financial statements: balance sheet, income statement, statement of changes in stockholders' equity, and statement of cash flows.

GAAS require that CPAs plan and perform auditing procedures to obtain reasonable assurance that financial statements are free from material misstatement. Under GAAS, an audit includes examining on a test basis and should include evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial-statement presentation.

Independence

In the performance of their work, CPAs must be independent of those they serve. Traditionally, independence has been defined as the ability to act with integrity and objectivity. In accordance with the rule on independence included in the SEC's independence rules and the Code of Professional Ethics and related AICPA interpretations, the independence of a CPA is considered to be impaired if, during the period of his or her professional engagement, the CPA or his or her firm had any direct or material indirect financial interest in the enterprise or had any loan to or from the enterprise or any officer, director, or principal stockholder thereof. The latter prohibition does not apply to the following loans from a financial institution when made under normal lending procedures, terms, and requirements:

- automobile loans and leases collateralized by the automobile
- loans in the amount of the cash surrender value of a life insurance policy
- borrowings fully collateralized by cash deposits at the same financial institution (for example, passbook loans)
- credit cards and cash advances under lines of credit associated with checking accounts with aggregate unpaid balances of $5,000 or less

Such loans must, at all times, be kept current by the CPA as to all terms.

Other loans have been grandfathered by the AICPA under recent ethics interpretations. These other loans (mortgage loans, other secured loans, and loans not material to the AICPA member's net worth) must, at all times, be current as to all terms and shall not be renegotiated with the client financial institution after the latest of—

- January 1, 1992;
- the date that the financial institution first becomes a client;
- the date the loans are sold from a nonclient financial institution to the client financial institution; or
- the date of becoming a member in the AICPA.

The examiner may decide under certain circumstances to test the independence of the CPA through reviews of loan listings, contracts, stockholder listings, and other appropriate measures. Concerns about independence should be identified in the report of examination.

The SEC has also released guidance relating to the independence of auditors for public institutions. According to SEC Rule 101, the independence of an auditor would be impaired if financial, employment, or business relationships exist between auditors and audit clients, and if there are relationships between auditors and audit clients in which the auditors provide certain nonaudit services to their audit clients. Much of the language found in the SEC's independence rules is incorporated in the Interagency Policy Statement on the Internal Audit Function and Its Outsourcing.

EXTERNAL AUDIT REPORTS

The external auditor generates various types of reports and other documents. These reports typically include—

- the standard audit report, which is generally a one-page document;
- a "management letter" in which the auditor confidentially presents detailed findings and recommendations to management; and
- an attestation report in which the auditor attests to management's assertion of internal controls and procedures over financial reports (for public companies and institutions subject to section 36 of the FDI Act); and
- other reports from the auditor to regulators during the audit period.

The major types of standard audit reports will never have a heading or other statement in the report that identifies which type it is. Rather, the type of report is identified by certain terminology used in the text of the report. The major types of standard audit reports are described below.

The *unqualified report,* sometimes referred to as a *clean opinion,* states that the financial statements are "presented fairly" in conformity with GAAP and that the necessary audit work was done. The *qualified report* may generally have the same language as the unqualified report but will use the phrase "except for" or some other qualification to indicate that some problem exists. The types of problems include a lack of sufficient evidential matter, restrictions on the scope of audit work, or departures from GAAP in the financial statements. This type of report is not necessarily negative but indicates that the examiner should ask additional questions of management.

An *adverse report* basically concludes that the financial statements are not presented fairly in conformity with GAAP. This type of report is rarely issued because auditors and management usually work out their differences in advance.

A *disclaimer* expresses no opinion on the financial statements. CPAs may issue a disclaimer when they have concluded that substantial doubt exists about the ability of the institution to continue as a going concern for a reasonable period of time. This disclaimer is intended to indicate that the CPA is not assuming any responsibility for these statements.

REVIEW OF THE EXTERNAL AUDITOR'S INDEPENDENCE AND AUDIT

Because of the professional and ethical standards of the public accounting profession, the Federal Reserve has concluded that the examiner should conduct an in-depth review of the competence and independence of the CPA only in unusual situations. One such situation would be a recent change in CPAs by a bank, particularly if the change was made after an audit had commenced.

Ordinarily, specific tests to determine independence are not necessary. However, there may be occasions when the examiner has sufficient reason to question the independence of a CPA or the quality of his or her work. For example, the examiner may discover that during the period of a CPA's professional engagement, which includes the period covered by the financial statements on which the CPA has expressed an opinion, the CPA or a member of his or her firm—

- had a direct financial interest in the bank;

- was connected with the bank in a capacity equivalent to that of a member of management or was a director of the bank;
- maintained, completely or in part, the books and records of the bank and did not perform audit tests with respect to such books and records; or
- had a prohibited loan from the bank (as discussed earlier).

In these and similar instances, the CPA would not have complied with professional standards.

The examiner should determine the scope of the CPA's examination by reviewing the most recent report issued by the CPA. If the audit is in progress or is planned to commence in the near future, the examiner should review any engagement letter to the bank from the CPA. The examiner also should obtain and review any adjusting journal entries suggested by the CPA at the conclusion of the examination. This should be done to determine whether such entries were the result of breakdowns in the internal control structure and procedures for financial reporting.

Under certain circumstances, a CPA may issue a qualified or adverse opinion or may disclaim an opinion on a bank's financial statements. In such circumstances, the examiner should first determine the reasons for the particular type of opinion issued. If the matters involved affect specific areas of the bank's operations, a review of the work performed by the CPA may help the examiner understand the problem that gave rise to this opinion. The examination procedures (section 1010.3) describes the steps the examiner should follow when conducting a review of the work performed by the CPA. (See the FFIEC interagency Policy Statement on the External Auditing Programs of Banks and Savings Associations (effective January 1, 2000) (SR-99-33)).

LIMITATIONS OF AUDITS AND AUDITED FINANCIAL STATEMENTS

Although auditing standards are designed to require the use of due care and objectivity, a properly designed and executed audit does not necessarily guarantee that all misstatements of amounts or omissions of disclosure in the financial statements have been detected. Moreover, a properly designed and executed audit does not guarantee that the auditor addressed FRB safety-and-soundness considerations. Examination personnel should be cognizant of the limitations inherent in an audit. The following examples illustrate some common limitations of audits:

- The auditor is not responsible for deciding whether an institution operates wisely. An unqualified audit report means that the transactions and balances are reported in accordance with GAAP. It does not mean that the transactions made business sense, that the associated risks are managed in a safe and sound manner, or that the balances can be recovered upon disposition or liquidation.
- The auditor's report concerning financial statements does not signify that underwriting standards, operating strategies, loan-monitoring systems, and workout procedures are adequate to mitigate losses if the environment changes. The auditor's report that financial statements fairly present the bank's financial position is based on the prevailing evidence and current environment, and it indicates that reported assets can be recovered in the normal course of business. In determining that reported assets can be recovered in the normal course of business, the auditor attempts to understand financial-reporting internal controls and can substitute other audit procedures when these controls are weak or nonexistent.
- The quality of management and how it manages risk are not considered in determining historical cost and its recoverability. Although certain assets and instruments are marked to market (for example, trading accounts), GAAP generally uses historical cost as the basis of presentation. Historical cost assumes that the entity is a going concern. The going-concern concept allows certain mark-to-market losses to be deferred because management believes the cost basis can be recovered during the remaining life of the asset.
- GAAP financial statements offer only limited disclosures of risks, uncertainties, and the other safety-and-soundness factors on which the institution's viability depends.
- Under GAAP, loan-loss reserves are provided for "probable losses" currently "inherent" (that is, anticipated future charge-offs are based on current repayment characteristics) in the portfolio. GAAP defines probable as the likelihood that a future event will occur, confirming the fact of the loss. Additionally, the amount of the loss must be reasonably estimable.

COMMUNICATION WITH EXTERNAL AUDITORS

GAAS requires that the external auditor can consider regulatory authorities as a source of competent evidential matter when conducting an audit of the financial statements of a banking organization. Accordingly, an external auditor may review communications from, and make inquiries of, the regulatory authorities.

Generally, the Federal Reserve encourages auditors to attend examination exit conferences upon completion of the examiner's field work or to attend other meetings concerning examination findings between supervisory examiners and an institution's management or board of directors (or a committee thereof). Banks should ensure that their external auditors are informed in a timely manner of scheduled exit conferences and other relevant meetings with examiners and of the FRB's policies regarding auditor attendance at such meetings.

When other conferences between examiners and management are scheduled (those that do not involve examination findings that are relevant to the scope of the external auditor's work), the institution should first obtain the approval of the appropriate Federal Reserve Bank personnel for the auditor to attend the meetings. The interagency policy statement of July 23, 1992, does not preclude the Federal Reserve from holding meetings with the management of banks without auditor attendance or from requiring that the auditor attend only certain portions of the meetings. (See SR-92-28.)

The 1992 interagency policy statement was issued to improve coordination and communication between external auditors and examiners. Examination personnel should provide banking organizations with advance notice of the starting date of the examination when appropriate, so management can inform external auditors in advance and facilitate the planning and scheduling of their audit work.

Some institutions prefer that audit work be completed at different times than examination work to reduce demands on their staff members and facilities. Other institutions prefer to have audit work and examination work performed during similar periods so the institution's operations are affected only at certain times during the year. By knowing when examinations are planned, institutions have the flexibility to schedule external audit work concurrent with, or separate from, examinations.

Meetings and Discussions Between External Auditors and Examiners

An external auditor may request a meeting with the FRB regulatory authorities involved in the supervision of the institution or its holding company during or after completion of examinations to inquire about supervisory matters relevant to the institution under audit. External auditors should provide an agenda in advance. The FRB regulatory authorities will generally request that management of the institution under audit be represented at the meeting. In this regard, examiners will generally only discuss with an auditor examination findings that have been presented to bank management.

In certain cases, external auditors may wish to discuss with examiners matters relevant to the institution without bank management representation. External auditors may request such confidential meetings with the FRB regulatory authorities, who may also request such meetings with the external auditor.

Information Required to Be Made Available to External Auditors

Section 931 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and section 112 of FDICIA (12 USC 1811) pertain to depository institutions insured by the FDIC that have engaged the services of an external auditor to audit the banking organization within the past two years. FIRREA and FDICIA require banks to provide the auditor with copies of the most recent Report of Condition (Call Report), report of examination, and pertinent correspondence or reports received from its regulator. This information is to be provided to the external auditor by the bank under audit, not by the FRB. In addition, banking organizations must provide the independent auditor with—

- a copy of any supervisory memorandum of understanding or written agreement between a federal or state banking agency and the bank put into effect during the period covered by the audit, and

- a report of any formal action taken by a federal or state banking agency during such period, or any civil money penalty assessed with respect to the bank or any banking organization–affiliated party.

Regulatory personnel should ascertain if the banking organization is in compliance with the requirements of section 931 of FIRREA (12 USC 1817(a)) and section 112 of FDICIA and should report instances of noncompliance in the report of examination.

Confidentiality of Supervisory Information

While the policies of the FRB regulatory authorities permit external auditors to have access to the information described above, institutions and their auditors are reminded that information contained in examination reports, inspection reports, and supervisory discussions—including any summaries or quotations—is confidential supervisory information and must not be disclosed to any party without the written permission of the FRB. Unauthorized disclosure of confidential supervisory information may lead to civil and criminal actions and fines and other penalties.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED modules for examination procedures:

- Management and Internal Control Evaluation
- Internal and External Audit Evaluation

The information in the first part of this section is reprinted from a publication of the Bank Administration Institute (BAI), entitled “Statement of Principle and Standards for Internal Auditing in the Banking Industry.” The second part of this section reproduces appendixes A and B from the February 9, 2006, Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters. (See section 1010.1 of this manual.)

A STATEMENT OF PRINCIPLE CONCERNING INTERNAL AUDITING IN THE BANKING INDUSTRY

Internal auditing is that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control within an organization and the quality of ongoing operations.

The systems of control comprise the plan of organization and all methods and measures designed to:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and corrected promptly.
- Promote operational efficiency.
- Encourage compliance with managerial policies, laws, regulations, and sound fiduciary principles.

Ongoing operations comprise all activities involved in the conduct of the organization’s business.

The internal auditor is accountable to the board of directors and executive management. This accountability precludes the auditor from organizational relationships that may conflict with the need for independence.

STANDARDS OF INTERNAL AUDITING IN THE BANKING INDUSTRY

Organization Standards

1. The organization shall have an internal audit function responsible for evaluating the adequacy, effectiveness and efficiency of its systems of control and the quality of ongoing operations.
2. The organization shall maintain an environment within which the auditor has the freedom to act.
3. The organization shall allocate sufficient resources to the audit function to enable it to conform to the standards of internal auditing.
4. The organization shall require management to respond formally to adverse audit findings and to take appropriate corrective action.
5. The organization’s systems of control shall include measurement of audit effectiveness and efficiency.

Personal Standards

1. An internal auditor shall have adequate technical training and proficiency.
2. An internal auditor shall maintain a sufficiently independent state of mind to clearly demonstrate objectivity in matters affecting audit conclusions.
3. An internal auditor shall respect the confidentiality of information acquired while performing the audit function.
4. An internal auditor shall only engage in activities that do not conflict with the interests of the organization.
5. An internal auditor shall adhere to conduct that enhances the professional stature of internal auditing.
6. An internal auditor shall exercise due professional care in the performance of all duties and in the fulfillment of all responsibilities.

Performance Standards

1. The internal auditor shall prepare a formal audit plan that covers all significant organizational activities over an appropriate cycle of time.
2. The audit plan shall include an evaluation of controls within new systems and significant modifications to existing systems before they become operational.
3. Audit procedures shall provide sufficient and competent evidential matter to support conclusions regarding the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.
4. The organization of the audit function and related administrative practice shall provide for the proper supervision of persons performing audits and for the proper review of work performed.

Communication Standards

1. The auditor shall prepare a formal report on the scope and results of each audit performed.
2. Each audit report shall contain an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations; the degree of compliance with previously evaluated systems of control; or an explanation of why an opinion cannot be expressed. When an adverse opinion is expressed, the report shall contain a statement about the exposures that may exist in the absence of corrective action.
3. The auditor shall communicate audit findings in a timely manner to the managers responsible for corrective action.
4. At least once each year the auditor shall make a summary report of audit activities to the board of directors and executive management. The report shall include an opinion on the overall condition of the organization's controls and operations.

COMMENTARY

The following comments are presented in order to promote the acceptance of the "Statement of Principle and Standards for Internal Auditing in the Banking Industry," to provide a context for the application of its concepts and to enhance the understanding of internal auditing. It is intended that the statement and the commentary will serve as a basis for the continuing advancement of the profession's influence and service.

Internal Auditing as a Discipline

Internal auditing is developing a broader perspective by recognizing that all operations are properly subject to control and within the scope of auditing. The internal auditor's concern for control should extend beyond accounting matters. This broader concept better serves the board of directors and executive management to whom the internal auditor is accountable. Bank Administration Institute believes the systems of control and ongoing operations, as defined herein, provide a preferred perspective for discussing internal auditing within the framework of the auditing discipline taken as a whole.

Concepts of Control

The systems of control exist to assure the achievement of intended results, to promote operating efficiency and to encourage compliance with policies and other established constraints. Although internal auditors have a definite interest in verifying the results of business activity, their primary concern must be the continuing effectiveness of the systems of control that influence business results. The important qualities that must be evaluated are adequacy, effectiveness and efficiency.

In evaluating adequacy, the auditor analyzes systems to determine that they include design features proper to the circumstances and reasonably sufficient to effect control. The evaluation of adequacy begins with the comparison of "what should be" to "what is." Initial audits and audits of proposed procedures or organization structures focus primarily on the adequacy of control.

In evaluating effectiveness, the auditor measures the degree of compliance with control features and the extent to which compliance serves the intended purposes. The question that must be answered is: "Do the controls work?"

In evaluating efficiency, the auditor judges the practicality of controls in terms of their cost relative to their intended benefit. It is not intended that the auditor should evaluate adequacy or effectiveness in absolute terms, nor is it intended that the auditor judge efficiency in absolute terms. An internal auditor's evaluation of efficiency is restricted to the controls themselves and does not extend to the measures of operating performance associated with the functioning of such controls. In judging efficiency, the internal auditor must conclude whether the benefits provided by the controls exceed their cost.

The systems of control and not the audit function:

- Provide reasonable assurance that assets are safeguarded, information (financial and other) is timely and reliable, and errors and irregularities are discovered and promptly corrected.
- Promote operational efficiency.
- Encourage adherence to managerial policies, laws, regulations and sound fiduciary principles.

Those members of management who are responsible for policy implementation are also responsible for the design and the maintenance of the systems of control. Internal auditors are responsible for that management function which independently evaluates the adequacy, effectiveness and efficiency of the systems of control. Internal auditors should make sure that those who rely on their opinions understand that no practical system can guarantee the quality of future performance.

Controls act as a positive force to facilitate successful operations as well as a negative one that restricts activities. Accordingly, the auditor should evaluate control systems in terms of the incentives they provide as well as the sanctions.

Safeguarding assets relates to physical, legal and all other protective means by which the organization assures the full realization of its resources.

All information should be subject to the systems of control. Timely information is that which anticipates a decision need and is available to the persons who will use it when they need it. Reliable information provides a sound basis for decision because of the authenticity of its source, the manner in which it is recorded and the form and content of its presentation.

The systems of control must detect and correct errors and irregularities when preventive controls fail. Sound systems of control contain safeguards that will counteract failures in other controls.

The systems of control should promote operational efficiency. The features of control systems that promote operational efficiency include the processes used to select and train personnel, establish procedures, set performance requirements, measure results and provide incentives.

Managerial policies, laws, regulations and sound fiduciary principles establish bounds within which the organization can conduct its business. The features of the control system that encourage compliance with these requirements include the separation of duties, the employment of persons likely to comply, the establishment of authority limits and the communication of expected conduct.

Ongoing Operations

Management must evaluate the quality of operations based on information provided by the control systems. Adequate control systems produce sufficient information to reliably appraise operations. To confirm that the control systems are adequate and effective, the internal auditor should independently evaluate the quality of ongoing operations. Only ongoing operations have future significance.

Internal auditors should express their opinion on whether the quality of ongoing operations is satisfactory or unsatisfactory. Satisfactory operations are those which, in the opinion of the auditor, require no extraordinary intervention by executive management or the directors. Conversely, unsatisfactory operations require extraordinary intervention before appropriate remedial action is likely to occur. A qualified opinion may be expressed by citing specific exceptions to satisfactory operations. Auditors may assess the quality of operations more precisely and report on grades of quality, provided the grades are clearly understood by management.

Circumstances may preclude the auditor from forming an opinion on the quality of ongoing operations. This, by itself, is significant because the information provided by the control systems should be adequate for the evaluation of ongoing operations.

Accountability

Accountability refers to the measures of effective audit performance. The organization standards of this statement define the conditions necessary to hold the auditor accountable for the other standards.

Only the board of directors can protect the auditor's need for independence; consequently, the board should be the final judge of the auditor's performance. The fact that the process of measurement may be done through an audit committee does not alter the auditor's ultimate accountability to the board.

Both the auditor and executive management have received a delegation of authority from the board: management to design and maintain systems of control; the auditor to evaluate these systems of control. Because the evaluation process exists to serve the design and maintenance responsibility, the auditor must also be accountable to executive management. This accountability, however, does not create the usual corollary right of the executive to directly apply sanctions or to otherwise restrict the auditor's functional independence. Such action, if necessary, must be decided by the board.

The auditor should be mindful that the audit function serves many users. The auditor has an obligation, if not accountability, to those users. The auditor's personal relationship with others should be characterized by integrity, open communication and mutual respect. User satisfaction should be an important consideration in the board's evaluation of audit performance.

Independence is a matter of personal quality rather than of rules. The auditor's relationships, as indicated by the plan of organization and by the way in which the work is conducted, must always be such that a presumption of independence logically follows in the mind of the observer.

Organization Standards

A banking organization can best evidence its support and commitment to the professional standards of internal auditing by formally adopting these standards.

The organization standards are prerequisites to the personal, performance and communication standards. The simply state that an internal auditor cannot be accountable for adherence to the other standards without the necessary resources and support of the organization.

Many banks cannot afford the services of a competent and independent internal auditor. It should be clearly understood that those banks are not in compliance with these standards. Their directors and executive management, therefore, bear the burden of providing additional supervision to assure the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations.

The organization shall provide and maintain an environment within which the internal auditor has the freedom to act. Persons whose duties and responsibilities are subject to audit cannot have the authority to regulate the scope of audit work nor the procedures considered necessary by the auditors. The auditor's responsibility to independently evaluate the systems of control must carry with it the authority to set the scope and choose the means of examination.

Budgeting should be based on a complete plan of audit that demonstrates fulfillment of the organization's audit needs and adherence to the standards of internal auditing. In committing resources to the internal audit function, the organization should expect the auditor to properly support requested allocations through the established budget process.

The audit process is not complete until the auditor is satisfied that audit findings have received appropriate attention. By requiring management to respond formally to audit findings, the organization contributes to the effectiveness of the audit function and increases the likelihood that the findings will receive appropriate attention.

The organization should measure the performance of its internal audit function in relation to the timeliness, efficiency and the quality of its work. Timeliness is indicated by scheduling the work in recognition of risk assessments and by the prompt issuance of reports. Efficiency is indicated by completing the work within the time budgeted. An efficient internal audit program also minimizes the time required by examiners and public accountants without affecting adequate coverage. Formal work programs, workpapers and the form and content of reports evidence the quality of an audit function. The organization should consider using the opinions formed by bank examiners, certified public accountants and other professional auditors to assist in this performance evaluation. Smaller banks may find the services offered by their correspondents include such evaluations.

Personal Standards

Personal standards relate to the qualifications of auditors, the quality of audit practice and the rules of professional conduct. They concern all persons who apply audit procedures under a delegation of authority from the board to support conclusions regarding the systems of control. Personal standards are prerequisites to performance and communication standards.

All persons engaged in the practice of internal auditing shall have the technical training and proficiency necessary to conduct their audit duties in accordance with these standards. Technical training and proficiency are separate requirements. Technical training relates to education; proficiency relates to the skill and judgment acquired through experience.

The qualified internal auditor will have successfully completed a course of study and training in disciplines having audit significance and will understand their application to banking. These disciplines include the principles of accounting, auditing, economics, finance, operations analysis, management, statistics, commercial law and computer science.

Experience is gained by working under the close supervision and review of an experienced professional. This relationship should make the job itself a vehicle for seasoning and refining the technical training acquired through formal education. On-the-job training should be carefully planned and organized. Those responsible for managing the audit function should define the elements of knowledge and judgment that may be gained from experience and establish a way to measure the resulting proficiency.

Proficiency is demonstrated by the proper exercise of professional judgment. It is difficult for users of professional services to accurately assess proficiency. Therefore, recognized professions, including internal auditing, provide certification programs for their practitioners. Each person engaged in the internal audit function can demonstrate proficiency by earning a professional designation such as chartered bank auditor, certified internal auditor or certified public accountant. The last two designations, however, require successful banking or related experience to demonstrate a practical knowledge of the industry.

The modern business environment demands that an internal auditor maintain proficiency by active participation in programs of continuing education and professional association.

There is no concept more important to internal auditing than independence. The essence of independence is intellectual honesty informing conclusions and expressing opinions. Conclusions must be reached fairly without bias or the propensity to prejudge circumstances. Opinions must be expressed forthrightly despite the conflicts that may arise. Although the appearance of independence relies on a plan of organization that grants the auditor freedom from conflicting accountabilities, the actual attainment of independence depends solely on the individual. The concept of independence is most fundamental to the definition and practice of auditing.

Independence is not isolation. Auditors should not allow their need for independence to inhibit the contacts and rapport necessary for a fully effective audit function.

Banking organizations properly require all employees to honor the confidentiality of financial and other information obtained during their employment. This requirement is all the more important for internal auditors because of the nature and scope of their work. Confidentiality also applies to the judicious use of information within the organization.

An internal auditor should not accept employment or participate in activities that compete or otherwise oppose the lawful objectives of the organization. Loyalty reflects integrity and credibility. Relationships which may, even by implication, raise doubt concerning the auditor's loyalty to the bank therefore must be avoided.

All members of a profession owe allegiance to their colleagues. The reputation of all depends to some degree on the conduct of each. Internal auditors develop professional recognition by supporting and participating in associations organized to serve their common needs. Each internal auditor is also obligated to maintain proficiency and awareness through self-education.

Due professional care imposes an ethical obligation on all auditors to demonstrate competency. Due care acts as a safeguard against negligence and oversight. Due professional care applies to the administrative practices that bear on the quality of audit results as well as to the use of audit procedures that provide sufficient competent evidence.

Due professional care is a subjective standard based on reasonableness. The duty of due professional care requires the auditor to know the extent of reliance that others within the organization place on audit results. When such reliance is unrealistic or misunderstood, the auditor should resolve the misunderstanding and temper unrealistic expectations.

The organization should require the presentation of audit findings in a manner that convinces management that the auditor exercised due professional care.

Performance Standards

The audit plan should be written and presented in a form that is suitable for critical review by audit committees, certified public accountants, regulatory examiners and others who must evaluate the adequacy of audit coverage.

An audit plan is based on a catalog of examinations that includes all significant activities of the organization classified by logical units for work scheduling. For example, demand deposit bookkeeping functions may be classified as three separate audits: overdraft control practices, confirmation of balances and bookkeeping operations.

The frequency of audit should be determined by reference to factors affecting risk, management information, customer satisfaction and the need to create an awareness of audit presence. Risk assessment involves audit judgment regarding how often and to what extent the systems of control must be evaluated.

In mature audit operations, the problem of balancing audit objectives with audit resources has usally been solved. Risk assessment in the context of audit planning does not normally change in the near range. The audit plan for each cycle does not prescribe a detailed listing of tests and procedures to be applied. These tactical steps are to be found in the work program.

The audit plan, which usually represents work contemplated for the current year, should present the information necessary to schedule and assign the work. It should cover resources requirements, administrative goals and objectives and the estimated costs of audit. Resource plans identify the number of persons needed, schedule their time (including such non-audit time as administration, vacation, lost days, staff training) and specify the level of ability. Administrative goals and objectives should reflect the audit implications of conditions that influence the organization. Audit costs should be identified in sufficient detail to encourage the audit manager to justify their cost and impact on the organization.

While cost justifying the audit plan, the audistor should recognize that the organization's cost of control includes its cost of auditing. In certain areas, efficiencies may best be achieved by strengthening the control systems as an alternative to audit coverage.

The audit plan shall include an evaluation of the adequacy of controls within new systems and significant modifications to existing systems before they become operational. This evaluation should include the controls designed into the conversion plan. Significant modifications are those that affect controls to an extent that audit concern is created regarding the organization's resulting exposure to loss.

The second performance standard concerns the timing of audit but not its scope. Identifying significant changes and establishing audit procedures is a matter of individual audit judgment. Modern complex systems are expensive to develop and maintain. Building adequate controls within the original design is usually less costly than adding them after the system is operational. The cost of evaluation, however, is usually no greater before implementation than after.

The reliability of audit results depends on the character of supporting evidence. Audit procedures should be selected and applied in a way that assures such evidence is sufficient and competent.

The term "sufficient" as used here means that enough evidence is assembled to assure that audit conclusions are well founded. The internal auditor's determination of what constitutes enough evidence is a matter of professional judgment relative to the controls and operations under evaluation. Frequently, sufficiency can be demonstrated by the application of statistical sampling techniques.

The term "competent" means relevant and valid. Competent evidence has the requisite ability to convince. Both the substance and the interrelationship of evidence demonstrate competence. Whereas sufficient is a quantitative concept, competent is a qualitative one.

Competency for audit purposes depends on the procedures used to obtain evidence. Direct knowledge, such as obtained by observation or inspection, is more reliable than indirect knowledge, such as obtained by confirmation and inquiry. Obtaining the most competent evidence, however, is not always feasible. Selecting and applying those procedures that collectively produce the most competent evidence under the circumstances demonstrates audits proficiency.

Audit work should be organized so that the objectives at each level of detail are clearly defined. Each phase of the work as well as the contribution of each person should be viewed by a superior. Audit management should review the audit programs, questionnaires and other planning features for completeness, applicability and efficiency. The reviewer should be satisfied that those who perform field work understand the systems under examination and the audit procedures that have been selected for application.

The auditor in charge of each assignment should perform a detailed review of the work as it is completed. No work should be accepted unless it complies with the standard of evidence. Audit management should conduct a comprehensive final review of the workpapers to determine that proper procedures were applied, sufficient evidence was assembled and all exceptions were properly evaluated in terms of their control significance. Audit management should also make interim field reviews.

Reviews must be documented. All auditors should appreciate the importance of the review process and perform their work in a manner that facilitates review. Review serves as an educational process as well as a control. Directors of banks employing only one auditor should supervise the auditor's work in a manner that provides a check on audit quality.

Communication Standards

The auditor has a responsibility to report the results of all audit work performed. Some auditors prefer to report only significant exceptions; however, this practice reinforces a negative view of the audit function. The auditor's responsibility to evaluate control systems and ongoing operations carries with it an obligation to report the results of that evaluation. Without a report, management does not have positive assurance that auditing is meeting its commitments. Consequently, management can only assume that adequate coverage is maintained and that the systems of control are functioning adequately, effectively and efficiently. By implication, audit reporting only on an exception basis extends the auditor's responsibility beyond what the actual work can support and causes misunderstanding.

Requiring auditors to express an opinion on the adequacy, effectiveness and efficiency of the systems of control and the quality of ongoing operations enables the board of directors, management and other interested parties to better judge the reliability of the control systems and ongoing operations. This service is a natural and logical part of the internal auditor's accountability.

Expressing an opinion imposes a serious obligation on the auditor. The requirement of due professional care extends to both the opinion and the commentary supporting it. Clear identification of the systems of control audited is the key to a meaningful opinion.

Each auditor should develop standard language for rendering an opinion. Standardization of language minimizes misunderstanding and promotes recognition of circumstances that require responsive action.

It is suggested that auditors develop their opinion statement along the following lines:

> "In our opinion (the audit subject's) operating and accounting procedures include those practices usually necessary to provide adequate and efficient control. Also in our opinion, the degree of compliance with such procedures provided effective control during the (period of audit). We found the quality of ongoing operations satisfactory."

This opinion assumes the auditor has reviewed the systems of control before they became operational and is satisfied that they include design features proper to the circumstances and reasonably sufficient to effect control. The second sentence of the opinion addresses the degree of compliance with control features previously found adequate and efficient. Audits of operations that are subject to a common control system such as a typical branch bank audit need not include a review of the system each time a unit audit is performed. The auditor, however, should be satisfied that all modifications to the existing system that significantly affect control have been evaluated.

Auditors occasionally form adverse conclusions concerning the adequacy, effectiveness or efficiency of the systems of control or the quality of ongoing operations. In these cases, they should qualify their opinion and identify exposures that may exist in the absence of corrective action. Risk measures the degree to which exposures are uncontrolled. The applicable equation is: Exposure minus control equals risk. A calculated risk is taken only when the exposure is fully identified and the implications of the lack of control are understood. To make an adverse opinion clear and meaningful, therefore, the auditor must identify relevant exposures and explain their significance.

Every audit report should identify the area audited and disclose all matters the auditor believes require responsive action by the recipient. Auditors should clearly distinguish between those matters to which they take exception and those that are reported for other reasons. The degree of detail reported is largely a matter of judgment, influenced greatly by the preferences of management. Some managements prefer to have all audit findings reported no matter how minor. Others prefer only a general description of significant findings. Auditors must bear in mind that their ultimate accountability demands that findings of major significance be brought to the attention of executive management and the board of directors.

The standards do not require the auditor to recommend corrective action. In practice, however, auditors find that many managements expect suggestions for corrective action, particularly when the technincal aspects of controls are involved. By suggesting corrective action, the auditor demonstrates a positive approach to the organization's problems. In making suggestions, auditors should recognize that their recommendations may not be the only means of achieving the control purpose intended. The focus of concern should be the control purpose and not the particular means selected from a range of acceptable choices.

A draft of each audit report should be made available to the manager of those operations under examination. Findings should be discussed with the manager before final issuance of the report. Any revisions should be similarly reviewed. The final report must clearly present audit findings and avoid language that may imply a meaning inconsistent with the supporting evidence. A review and a discussion of the draft assure this result.

Auditors must establish the facts of their findings but do not have to obtain complete management acceptance of their comments before issuing a report. Auditors should be prepared for occasional conflict and disagreement.

The ease with which auditors can retrieve information, support fact and amplify findings validates the adequacy and the quality of audit evidence. The extent to which auditors gain acceptance of their comments ultimately measures the effectiveness of internal auditing's contribution to the organization.

The timeliness with which audit findings are reported is very important and often critical for effective response. When timeliness is critical, the auditor should communicate findings promptly and not await the preparation of a formal report. Findings should be communicated to the manager whose operation is directly affected.

The extent and frequency of audit reports required by the board of directors varies with the organization. At least annually, however, the auditor shall formally report to the board of directors and executive management. The board of directors and executive management are entitled to a report that measures audit performance against plan and provides information normally required to establish accountability. The auditor should use this opportunity to promote an understanding of the audit function and how it serves the organization.

In the summary report, the auditor should express an opinion on the overall condition of the organization's controls and ongoing operations. The report should present all known control problems of significance as well as an evaluation of corrective action taken. Although the report is formal, it should be presented personally to ensure proper interpretation and to provide the benefit that flows from the exchange of information and concerns.

Fraud and the Auditor's Responsibility

The auditor is charged with understanding the purposes of the business, the control practices usually necessary to achieve them, and the type of evidence that indicates they will continue to be achieved. The following questions are prerequisite to evaluating the systems of control: What is the purpose of the system? How is it controlled? What can go wrong?

Audit proficiency includes the ability to evaluate fraud exposures. Sufficient information is available in the literature on auditing concerning how frauds may be committed in banking. The auditor should be familiar with that literature.

The systems of control and not the internal audit function provide the primary assurance against fraud. Internal auditors, however, must evaluate the capability of the systems to achieve that end. When in doubt, the auditor should consider applying additional procedures to determine if fraud has actually occurred.

In fixing the internal auditor's responsibility for detecting fraud, it should be recognized that the internal auditor cannot be responsible for detecting irregular transactions for which there is no record, e.g., an unrecorded receipt of cash from a source for which there is no evidence of accountability; an isolated transaction that does not recur, e.g., a single fraudulent loan; or irregularities that are well concealed by collusion. However, in the usual course of the audit cycle, the internal auditor should detect irregularities that significantly affect the financial statements, repeatedly follow a suspicious pattern of concurrence, or those that can be detected by a reasonable audit sampling. Internal auditors must also accept responsibility for those irregularities that result from their failure to report known weaknesses in the systems of control.

In judging the preventive capacity of the control systems and the internal auditor's responsibility, the principle of relative risk should not be ignored, namely, costs must be balanced against intended benefit.

CONCLUSION

Professional internal auditors can contribute a wealth of information to their organizations over and above the assurance they provide by evaluating the quality of control systems and ongoing operations. The word, "audit," comes from the Latin word, *audire*, meaning to hear. Internal auditors should be good listeners and observers. They should demonstrate an in-depth understanding of the strengths and weaknesses of the organization, the accomplishments and current problems of its departments, the quality of its services, the pride and concerns of its people and the efficiencies and diseconomies of its operations. In turn, executives and directors should listen to professional internal auditors and capitalize on their observations.

EXAMPLES OF UNSAFE AND UNSOUND LIMITATION-OF-LIABILITY PROVISIONS

The following information was contained in appendix A of the February 9, 2006, interagency advisory.

Presented below are some of the types of limitation-of-liability provisions (with an illustrative example of each type) that the agencies observed in financial institutions' external audit engagement letters. The inclusion in external audit engagement letters or agreements related to audits of any of the illustrative provisions (which do not represent an all-inclusive list) or any other language that would produce similar effects is considered an unsafe and unsound practice.

1. "Release from Liability for Auditor Negligence" Provision

In this type of provision, the financial institution agrees *not* to hold the audit firm liable for *any* damages, *except* to the extent determined to have resulted from willful misconduct or fraudulent behavior by the audit firm.

Example: In no event shall [the audit firm] be liable to the Financial Institution, whether a claim be in tort, contract or otherwise, for any consequential, indirect, lost profit, or similar damages relating to [the audit firm's] services provided under this engagement letter, except to the extent finally determined to have resulted from the willful misconduct or fraudulent behavior of [the audit firm] relating to such services.

2. "No Damages" Provision

In this type of provision, the financial institution agrees that *in no event* will the external audit firm's liability include responsibility for any compensatory (incidental or consequential) damages claimed by the financial institution.

Example: In no event will [the audit firm's] liability under the terms of this Agreement include responsibility for any claimed incidental or consequential damages.

3. "Limitation of Period to File Claim" Provision

In this type of provision, the financial institution agrees that *no* claim will be asserted after a fixed period of time that is shorter than the applicable statute of limitations, effectively agreeing to limit the financial institution's rights in filing a claim.

Example: It is agreed by the Financial Institution and [the audit firm] or any successors in interest that no claim arising out of services rendered pursuant to this agreement by, or on behalf of, the Financial Institution shall be asserted more than two years after the date of the last audit report issued by [the audit firm].

4. "Losses Occurring During Periods Audited" Provision

In this type of provision, the financial institution agrees that the external audit firm's liability will be limited to any losses occurring during periods covered by the external audit, and will *not* include any losses occurring in later periods for which the external audit firm is not engaged. This provision may not only preclude the collection of consequential damages for harm in later years, but could preclude any recovery at all. It appears that no claim of liability could be brought against the external audit firm until the external audit report is actually delivered. Under such a clause, any claim for liability thereafter might be precluded because the losses did not occur during the period covered by the external audit. In other words, it might limit the external audit firm's liability to a period before there could be any liability. Read more broadly, the external audit firm might be liable for losses that arise in subsequent years only if the firm continues to be engaged to audit the client's financial statements in those years.

Example: In the event the Financial Institution is dissatisfied with [the audit firm's] services, it is understood that [the audit firm's] liability, if any, arising from this engagement will be limited to any losses occurring during the periods covered by [the audit firm's] audit, and shall not include any losses occurring in later periods for which [the audit firm] is not engaged as auditors.

5. "No Assignment or Transfer" Provision

In this type of provision, the financial institution agrees that it will not assign or transfer any claim against the external audit firm to another party. This provision could limit the ability of another party to pursue a claim against the external auditor in a sale or merger of the financial institution, in a sale of certain assets or a line of business of the financial institution, or in a supervisory merger or receivership of the financial institution. This provision may also prevent the financial institution from subrogating a claim against its external auditor to the financial institution's insurer under its directors' and officers' liability or other insurance coverage.

Example: The Financial Institution agrees that it will not, directly or indirectly, agree to assign or transfer any claim against [the audit firm] arising out of this engagement to anyone.

6. "Knowing Misrepresentations by Management" Provision

In this type of provision, the financial institution releases and indemnifies the external audit firm from any claims, liabilities, and costs attributable to any knowing misrepresentation by management.

Example: Because of the importance of oral and written management representations to an effective audit, the Financial Institution releases and indemnifies [the audit firm] and its personnel from any and all claims, liabilities, costs, and expenses attributable to any knowing misrepresentation by management.

7. "Indemnification for Management Negligence" Provision

In this type of provision, the financial institution agrees to protect the external auditor from third-party claims arising from the external audit firm's failure to discover negligent conduct by management. It would also reinforce the defense of contributory negligence in cases in which the financial institution brings an action against its external auditor. In either case, the contractual defense would insulate the external audit firm from claims for damages even if the reason the external auditor failed to discover the negligent conduct was a failure to conduct the external audit in accordance with generally accepted auditing standards or other applicable professional standards.

Example: The Financial Institution shall indemnify, hold harmless and defend [the audit firm] and its authorized agents, partners and employees from and against any and all claims, damages, demands, actions, costs and charges arising out of, or by reason of, the Financial Institution's negligent acts or failure to act hereunder.

8. "Damages Not to Exceed Fees Paid" Provision

In this type of provision, the financial institution agrees to limit the external auditor's liability to the amount of audit fees the financial institution paid the external auditor, regardless of the extent of damages. This may result in a substantial unrecoverable loss or cost to the financial institution.

Example: [The audit firm] shall not be liable for any claim for damages arising out of or in connection with any services provided herein to the Financial Institution in an amount greater than the amount of fees actually paid to [the audit firm] with respect to the services directly relating to and forming the basis of such claim.[1]

FREQUENTLY ASKED QUESTIONS ON THE APPLICATION OF THE SEC's AUDITOR-INDEPENDENCE RULES

The following information is contained in appendix B of the February 9, 2006, interagency advisory.

Question[2]

Inquiry was made as to whether an accountant who certifies financial statements included in a registration statement or annual report filed with the commission under the Securities Act or the Exchange Act would be considered independent if he had entered into an indemnity agreement with the registrant. In the particular illustration cited, the board of directors of the registrant formally approved the filing of a registration statement with the commission and agreed to indemnify and save harmless each and every accountant who certified any part of such statement "from any and all losses, claims, damages or liabilities arising out of such act or acts to which they or any of them may become subject under the Securities Act, as amended, or at 'common law,' other than for their willful misstatements or omissions."

Answer

When an accountant and his client, directly or through an affiliate, have entered into an agreement of indemnity which seeks to assure to the accountant immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened. Such condition must frequently induce a departure from the standards of objectivity and impartiality which the concept of independence implies. In such difficult matters, for example, as the determination of the scope of audit necessary, existence of such an agreement may easily lead to the use of less extensive or thorough procedures than would otherwise be followed. In other cases it may result in a failure to appraise with professional acumen the information disclosed by the examination. *Consequently, the accountant cannot be recognized as independent for the purpose of certifying the financial statements of the corporation.*

Question

Has there been any change in the commission's long-standing view (Financial Reporting

1. The agencies also observed a similar provision that limited damages to a predetermined amount not related to fees paid.

2. The subtitles in this section have been revised for this manual.

Policies—Section 600—602.02.f.i., “Indemnification by Client”) that when an accountant enters into an indemnity agreement with the registrant, his or her independence would come into question?

Answer

No. When an accountant and his or her client, directly or through an affiliate, enter into an agreement of indemnity that seeks to provide the accountant immunity from liability for his or her own negligent acts, whether of omission or commission, the *accountant is not independent.* Further, including in engagement letters a clause that a registrant would release, indemnify or hold harmless from any liability and costs resulting from *knowing misrepresentations by management would also impair the firm’s independence.*[3]

3. U.S. Securities and Exchange Commission; Office of the Chief Accountant: Application of the Commission’s Rules on Auditor Independence—Frequently Asked Questions; Other Matters, Question 4 (issued December 13, 2004).

Examiners are expected to assess the adequacy of an institution's internal controls—the involved procedures, processes, and systems of its internal control structure. In so doing, they may refer to the available Internal Control Questionnaire(s) pertaining to the various transactions and activities discussed at the end of most sections of the manual. (See also section 1010.1.) When assessing the adequacy of a bank's internal control system and structure, the examiner needs to have a good understanding of the meaning of internal control and be able to evaluate its design and effectiveness. Internal control is a process initiated by a bank's board of directors, management, and other personnel, and is designed to provide reasonable assurance that specific objectives are achieved as to the bank's (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) extent of compliance with applicable laws and regulations.[1]

The concept of control structure involves the controls that have been established and the control environment—management's monitoring of procedures, activities, and attitudes. Internal control is part of the bank's basic operations.

The components of internal control are

- *Control environment*—the environment established by the bank's employees who are responsible for its operations, including their ethical values, integrity, and competence
- *Risk assessment*—the identification, analysis, and management of risks
- *Control activities*—the institution's established policies and procedures that are designed to provide assurance that appropriate actions, which are determined by management, are taken to address identified risks
- *Information and communication*—the bank's activities that provide the basis for the gathering and exchange of information that is needed to conduct, manage, and control the organization
- *Monitoring*—the bank's continuous monitoring of the internal controls system and structure to allow for appropriate and necessary changes.

The components of internal control overlap the internal control objectives. The components of internal control must be addressed individually to assess their effectiveness relative to a specific objective.

The bank's board of directors and senior management have an important role in ensuring the adequate development, execution, maintenance, and compliance monitoring of the bank's internal controls. When determining the adequacy of a bank's management, examiners should carefully analyze and review its internal control systems, processes, and procedures.

STATEMENT ON REQUIRED ABSENCES FROM SENSITIVE POSITIONS

One of the many basic tenets of internal control is that a bank needs to ensure that its employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks. Such a requirement enhances the viability of a sound internal control environment because most frauds or embezzlements require the continuous presence of the wrongdoer. After making this assessment, the bank should require that employees in sensitive key positions, such as trading and wire transfer, not be allowed to transact or otherwise carry out, either physically or through electronic access, their assigned duties for a minimum of two consecutive weeks per year. The prescribed period of absence should be sufficient to allow all pending transactions to clear. The bank should also require that an individual's daily work be processed by another employee during the employee's absence. See SR-96-37, which emphasizes the need for a bank to conduct an assessment of significant risk areas before developing a policy on required absences from sensitive positions.

A comprehensive system of internal controls is essential for a bank to safeguard its assets and capital, and to avoid undue reputational and legal risk. Senior management is responsible for establishing an appropriate system of internal controls and monitoring compliance with that system. Although no single control element

1. For additional information on internal controls, see the Committee of Sponsoring Organizations of the Treadway Commission's study on internal controls, *Internal Control—Integrated Framework* (AICPA, 1992).

should be relied on to prevent fraud and abuse, these acts are more easily perpetrated when proper segregation and rotation of duties do not exist. As a result, the Federal Reserve reemphasizes the following prudent banking practices that should be incorporated into a bank's internal control procedures. These practices are designed to enhance the viability of a sound internal control environment, as most internal frauds or embezzlements necessitate the constant presence of the offender to prevent the detection of illegal activities.

When developing comprehensive internal control procedures, each bank should first make a critical assessment of its significant areas and sensitive positions. This assessment should consider all employees, but should focus more on those with authority to execute transactions, those with signing authority and access to the books and records of the bank, as well as those employees who can influence or cause such activities to occur. Particular attention should be paid to areas engaged in trading and wire-transfer operations, including personnel who may have reconciliation or other back-office responsibilities.

After producing a profile of high-risk areas and activities, it would be expected that a minimum absence of two consecutive weeks per year be required of employees in sensitive positions. The prescribed period of absence should, under all circumstances, be sufficient to allow all pending transactions to clear and to provide for an independent monitoring of the transactions that the absent employee was responsible for initiating or processing. This practice could be implemented through a requirement that affected employees take vacation or leave, the rotation of assignments in lieu of required vacation, or a combination of both so the prescribed level of absence is attained. Some banks, particularly small community banks, might consider compensating controls such as continuous rotation of assignments in lieu of required absences to avoid placing an undue burden on the bank or its employees.

For the policy to be effective, individuals having electronic access to systems and records from remote locations must be denied this access during their absence. Similarly, indirect access can be controlled by not allowing others to take and carry out instructions from the absent employee. Of primary importance is the requirement that an individual's daily work be processed by another employee during his or her absence; this process is essential to bring to the forefront any unusual activity of the absent employee.

Exceptions to the required-absence policy may be necessary from time to time. However, management should exercise the appropriate discretion and properly document any waivers that are granted. Internal auditing should be made aware of individuals who receive waivers and the circumstances necessitating the exceptions.

If a bank's internal control procedures do not include the above practices, they should be promptly amended. After the procedures have been enhanced, they should be disseminated to all employees, and the documentation regarding their receipt and acknowledgment maintained. Additionally, adherence to the procedures should be included in the appropriate audit schedules, and the auditors should be cognizant of potential electronic access or other circumventing opportunities.

The development and implementation of procedures on required absences from sensitive positions is just one element of an adequate control environment. Each bank should take all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.

Required Absences from Sensitive Positions Examination Objectives

Effective date April 2009

1. To determine whether a critical assessment has been performed of a bank's significant areas and sensitive positions.
2. To ascertain that sound internal controls exist, including policies and procedures that provide assurances that employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks per year.
3. To ascertain whether the bank has taken all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.
4. To establish that the appropriate audit schedules and the audits include a review of minimum absence policies and procedures, including potential electronic access or other circumventing actions by employees.

1. Determine that a profile of high-risk areas and activities is performed on a regular, periodic basis.
2. Ascertain if employees assigned to sensitive positions are required to be absent for a minimum of two weeks per year while—
   a. pending, sensitive transactions are monitored while they clear, and
   b. daily work is monitored and processed by another employee during the regularly assigned employee's absence.
3. Determine if required internal control procedures for minimum absences (for example, rotation of assignments, vacation or leave, or a combination of both) are being used in sensitive operations such as trading, trust, wire transfer, reconciliation, or other sensitive back-office responsibilities.
4. Ascertain if appropriate policies, limits, and verification procedures have been established and maintained for an effective overall risk-management system.
5. Determine whether the bank—
   a. prohibits others from taking and carrying out instructions from the absent employees, and
   b. prevents remote electronic access to systems and records involving sensitive transactions during the regularly assigned employee's required minimum two-week absence.
6. Ascertain if waivers from the bank's two-week minimum absence policies and procedures involving sensitive positions are documented.
7. Determine that the appropriate audit schedules and the audits include a review of such procedures, including potential electronic access or other circumventing actions by employees.

The guidance[1] discussed below highlights generally the accounting and reporting requirements unique to business combinations resulting in bargain purchase gains. The guidance does not provide a comprehensive discussion on all aspects of accounting for business combinations. (See SR-10-12 and its attachment.)

SUPERVISORY CONSIDERATIONS

Compliance with GAAP and Regulatory Reporting Requirements

Accurate regulatory reports are critical for effective supervision and, because of their public availability, for enhancing the transparency of an institution's risk profile and financial position. Business combinations, including bargain purchase transactions and assisted transactions, should be accounted for in accordance with the Financial Accounting Standards Board's Accounting Standards Codification (ASC) Topic 805, "Business Combinations." The management of an acquiring institution is responsible for preparing regulatory reports in accordance with generally accepted accounting principles (GAAP), regulatory reporting requirements, and relevant supervisory guidance. The complexity of the accounting requirements related to a business combination does not relieve management of this responsibility and should be factored into management's overall analysis of the practicability of a potential acquisition. The management of each institution is responsible for establishing and maintaining appropriate governance and an effective internal control structure over the preparation of regulatory reports commensurate with the institution's size, complexity, and risk profile. This structure should include written policies and procedures that provide clear guidelines on accounting and reporting matters related to business combinations. Management is encouraged to discuss applicable regulatory reporting requirements and supervisory considerations with its primary federal regulator prior to consummating a business combination.

1. Part III of the June 7, 2010, "Interagency Supervisory Guidance on Bargain Purchases and FDIC- and NCUA-Assisted Acquisitions" was issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the former Office of Thrift Supervision.

Fair-Value Measurements

The valuation of the assets acquired and liabilities assumed in a business combination presents accounting and supervisory challenges. For example, many of these assets and liabilities are illiquid and lack quoted market prices, which complicates the estimation of their acquisition-date fair values. Thus, a key issue underlying fair-value estimates is the appropriateness of inputs and the appropriate selection and use of valuation techniques. Some valuation techniques employ complex models and, therefore, warrant further supervisory review. For example, reliability concerns may arise when the institution does not use clear and rigorous valuation techniques or where one or more significant inputs to a valuation estimate are not observable, even indirectly, from active markets. This is especially true when estimating the fair value of illiquid financial instruments, indemnification assets, and identifiable intangible assets that are acquired in a business combination.

It is management's responsibility to report fair values in accordance with ASC Topic 820, "Fair Value Measurement." Because of the significant impact fair-value measurements and any resultant goodwill or bargain purchase gain have on the financial statements, management should have appropriate written fair-value measurement policies, procedures, and controls in place. These policies, procedures, and controls should be executed by experienced and qualified individuals knowledgeable in both GAAP and regulatory reporting requirements for business combinations. Furthermore, management's fair-value measurements should be well supported and are subject to review by examiners.

If management does not possess the expertise to identify and measure the identifiable assets acquired and the liabilities assumed in a business combination (and the equity or member interests in the acquiree in a combination of mutual institutions), management should engage a qualified third-party expert to provide professional guidance and support for the preparation of fair-value measurements required by ASC Topic 805 and determined in accordance with ASC Topic 820. For example, management may use a third party to estimate the expected cash flows and the fair value of a loan portfolio acquired in an assisted acquisition (and the related expected cash flows and fair value of an FDIC loss-sharing indemnification asset). The use of outside resources, however, does not relieve management of its responsibility to ensure that fair-value estimates are measured in accordance with GAAP. Management must sufficiently understand the bases for the measurement and valuation techniques used by outside parties to determine the appropriateness of these techniques, the underlying inputs and assumptions, and the resulting fair-value measurements.

Retrospective Adjustments of Fair-Value Measurements during the Measurement Period

During the measurement period, management should finalize its fair-value measurement estimates and retrospectively adjust the provisionally recorded amounts to reflect the information it was seeking about the acquisition-date facts and circumstances promptly after receipt of this information. The existence of a measurement period does not permit management to delay completion of comprehensive fair-value measurements that conform to the requirements of ASC Topic 820. Rather, at the earliest possible reporting date, management should establish and report appropriate fair-value estimates for the identifiable assets acquired and liabilities assumed in a business combination (and the equity or member interests in the acquiree in a combination of mutual institutions).

An acquiring institution's regulatory capital is subject to retrospective adjustments made during the measurement period. Although bargain purchase gains are reported in earnings and included in the computation of regulatory capital under the agencies' capital standards, the acquiring institution's primary federal regulator may determine an estimated bargain purchase gain lacks sufficient necessary permanence to rely on the estimate as a component of regulatory capital.

The Federal Reserve System relies on the timely and accurate filing of regulatory reports by domestic and foreign financial institutions. Data collected from regulatory reports facilitate early identification of problems that can threaten the safety and soundness of reporting institutions; ensure timely implementation of the prompt-corrective-action provisions required by law; and serve other legitimate supervisory purposes. Certain regulatory report information is used for public disclosure so investors, depositors, and creditors can better assess the financial condition of the reporting banks. Information that comes primarily from the Consolidated Reports of Condition and Income (Call Reports) is used to prepare the Uniform Bank Performance Report (UBPR), which employs ratio analyses to detect unusual or significant changes in a bank's financial condition as of the reporting dates. The UBPR is also used to detect changing patterns of behavior in the entire banking system; consequently, any inaccurate data in the regulatory reports may result in ratios that conceal deteriorating trends in the bank or the industry.

Generally, all regulatory reports of financial condition and income that domestic and foreign banking organizations file with the Federal Reserve are required by statute or regulation. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) amended various banking statutes to enhance the Federal Reserve's authority to assess civil money penalties against state member banks, bank holding companies, and foreign institutions that file "late," "false," or "misleading" regulatory reports. The civil money penalties also can be assessed against individuals who cause or participate in such filings.

The Federal Reserve has identified a late regulatory report as an official copy of a report that is not received by the Reserve Bank or its designated electronic collection agent in a timely manner. Each bank must file its Call Report in one of the following two ways:

- A bank may use computer software to prepare its report and then submit the report directly to the Federal Financial Institutions Examination Council's (FFIEC) Central Data Repository (CDR), an Internet-based system for data collection or
- The institution may complete its reports in paper form and arrange with a software vendor or another party to convert its paper reports into the electronic format that can be processed by the CDR. The software vendor or other party then must electronically submit the data file containing the bank's Call Report to the CDR.

The filing of a Call Report in paper form directly with the FDIC or with the appropriate Federal Reserve Bank is not an acceptable method of submission.

Reserve Banks will monitor the filing of all regulatory reports to ensure that they are filed, as required, on a timely basis and that they are accurate and not misleading. The Federal Reserve System's Committee on Current Series Reporting, which consists of staff from the statistics functions at each of the Reserve Banks and at the Board, will play an active role in this process. (See SR-04-15.) Many reporting errors can be screened through validity edit checks. Also, Reserve Banks have additional monitoring procedures that they use to confirm the timely submission of reports and to confirm that the reports are accurate and not misleading. On a case-by-case basis, the Reserve Banks will continue to determine if and when a financial institution or other banking organization is a chronic late, inaccurate, or false reporter; in these cases, the Banks will determine what supervisory action, if any, to recommend for a noncompliant reporter.

The filing of a false report generally involves the submission of mathematically incorrect data, such as addition errors or transpositions, or the submission of a regulatory report without its appropriate schedules. Conversely, the filing of a misleading report involves some degree of negligent behavior on the part of the filer that results in the submission of inaccurate information to the Federal Reserve.

REVIEW AND REFILING OF REGULATORY REPORTS

Review of regulatory reports involves determining whether the management of the member bank has submitted all required reports to the Federal Reserve in a timely and accurate manner. The examiner assigned to a specific area of examination is responsible for reviewing the reports relating to that area and for verifying that they are accurate and meet statutory and regulatory requirements. If the examiner finds a material difference in the reports, management should be instructed to refile corrected copies, if appropriate.

Examiners should discuss on the "Examination Conclusions and Comments" and "Matters Requiring Board Attention" pages of the examination report material errors or the filing of chronically late reports. (See section 6000.1.) They should also discuss with Reserve Bank staff any regulatory report filing that is considered misleading, such a report could lead to the issuance of criminal referrals against the involved individuals. In addition, management should be reminded that civil money penalties or other enforcement proceedings could occur as a result of chronically late or false regulatory report filing.

Banks should maintain effective manual or automated internal systems and procedures to ensure that reporting meets the appropriate regulatory requirements. Banks should develop clear, concise, and orderly workpapers to support the compilation of data. Preparation of proper workpapers provides not only a logical tie between report data and the bank's financial records but also facilitates accurate reporting and verification. Ideally, as part of an effective internal control program, bank management should implement a procedure to verify the compilation of the data. At a minimum, an independent person or department should verify the data that have been compiled for inclusion in the report.

A bank's internal control and audit programs for regulatory reports should be sufficient to ensure that all required reports are submitted on time and are accurate. The specific internal controls a bank employs to meet those objectives depend largely on the volume of reports, the scope of a bank's operations, and the complexity of its accounting system.

COMMONLY REQUIRED REGULATORY REPORTS

This section describes the regulatory reports most commonly required either to be submitted by the member bank to the Federal Reserve Bank or the Board, or to be maintained by the member bank for review during an examination.

Consolidated Reports of Condition and Income

Under 12 USC 324 and the Board's Regulation H, all state member banks are required to file Consolidated Reports of Condition and Income (Call Reports) as of the last day of each calendar quarter. The specific reporting requirements, including the reporting form to be used (for example, FFIEC 031 or FFIEC 041), depend on the asset size of the bank and whether it has a foreign office. Details of the appropriate reporting guidelines, along with the specific reporting form to be filed, are found in the instructions for preparation of Reports of Condition and Income. The reporting forms and instructions can be found on the FFIEC's website: www.ffiec.gov.

The bank should submit completed Call Reports to the CDR no later than 30 calendar days after the report date. Any bank with more than one foreign office, other than a shell branch or international banking facility, must submit data to the CDR no later than 35 days after the report date. State member banks are *not* required to publish their Reports of Condition or Income, according to federal statute. However, a state member bank may be required to publish its Report of Condition under state law.

The Report of Condition provides consolidated, detailed financial information on assets, liabilities, capital, and off-balance-sheet activity, which permits a uniform analysis and comparison of the reporting bank's data to that of other insured banks. The report also aggregates certain figures on loans to executive officers, directors, principal shareholders, and their related interests. The Report of Income provides information such as consolidated earnings, changes in capital accounts and the allowance for loan and lease losses, and charge-offs and recoveries.

The examiner should carefully review both reports to ensure that all pertinent data have been reported and are properly categorized in accordance with the instructions. To understand a particular bank's Call Report, the examiner must understand the bank's accounting methods as well as the information located in, and the relationships between, the bank's general books and subsidiary ledgers. This understanding can be obtained only by a careful review of the workpapers used in the preparation of these reports and their supplementary schedules.

REPORTS REQUIRED BY THE MONETARY CONTROL ACT OF 1980 AND THE INTERNATIONAL BANKING ACT OF 1978

The Federal Reserve has established a basic deposits-reporting framework for administering Regulation D, Reserve Requirements of Depository Institutions, and for constructing, analyzing, and controlling the monetary and reserves aggregates. The framework consists of four categories of deposit reporting. Every institution is placed into one of these four categories for deposit reporting purposes.[1] In general, the larger the institution, the more detailed or more frequent the institution will have to report.

The first two reporting categories, characterized as "detailed reporting," apply to those institutions that are not exempt from reserve requirements ("non-exempt" institutions). The last two reporting categories, characterized as "reduced reporting," apply to institutions that are exempt from reserve requirements ("exempt" institutions). The reserve-requirement "exemption amount" is the amount of total reservable liabilities at each depository institution that is subject to a zero-percent reserve requirement. The exemption amount is used to make the distinction between detailed deposit reporting and reduced reporting.

- Institutions with net transaction accounts equal to or less than the exemption amount over prescribed periods are exempt from reserve requirements and are subject to reduced reporting (categories 3 and 4).
- Institutions with net transaction accounts greater than the exemption amount over prescribed periods are *not* exempt from reserve requirements and are subject to detailed reporting (categories 1 and 2).

Both measures are indexed annually; see Regulation D for the appropriate exemption and cutoff amounts.

The exemption amount and the deposit cutoff for any one calendar year are used by the Federal Reserve to determine deposit-reporting panels in July, effective for September of that year, which continues to September of the following year. All deposit reports are mandatory.

1. Depository institutions that are required to maintain reserves are defined in section 204.1(c) of Regulation D (12 CFR 204.1(c)).

Reporting Categories

"Non-exempt" institutions subject to detailed reporting file the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). Institutions file the report either weekly or quarterly, generally depending on the level of an institution's deposits. The report is used in the calculation of reserve requirements.

"Exempt" institutions subject to "reduced reporting" file either the Annual Report of Deposits and Reservable Liabilities (FR 2910a) or no report at all, depending on their deposit levels.

Report forms and instructions can be found on the Federal Reserve Board's website.

Category One

Depository institutions (other than banking Edge and agreement corporations and U.S. branches and agencies of foreign banks) with net transaction accounts greater than the exemption amount and with a sum of total transaction accounts, savings deposits, and small time deposits greater than or equal to the nonexempt deposit cutoff, or with a sum of total transaction accounts, savings deposits, and small time deposits greater than or equal to the reduced reporting limit, regardless of the amount of net transaction accounts, will be required to submit the FR 2900 weekly.

Banking Edge and agreement corporations and U.S. branches and agencies of foreign banks, regardless of size, must also submit the FR 2900 weekly. They are not eligible for reporting categories 2 through 4 below.

The weekly reporting period for the FR 2900 covers the seven-day period beginning on Tuesday and ending the following Monday.

Category Two

Depository institutions with net transaction accounts greater than the exemption amount and with a sum of total transaction accounts, savings deposits, and small time deposits less than the nonexempt deposit cutoff are required to submit the FR 2900 once each quarter, in March, June, September, and December.

The quarterly reporting period for the FR 2900 covers the seven-day period beginning on the third Tuesday of the report month and ending the following Monday.

Category Three

Depository institutions with net transaction accounts less than or equal to the exemption amount and with total deposits greater than the exemption amount but with total transaction accounts, savings deposits, and small time deposits below the reduced reporting limit are required to submit the FR 2910a. This report is filed as of June 30 each year.

Category Four

Depository institutions whose net transaction accounts and total deposits are less than or equal to the exemption amount are not required to submit any Federal Reserve deposit report as long as data on the level of an institution's deposits are readily available on a condition report.

Institutions for which deposit data are not readily available on a condition report will be required to submit the FR 2910a report to determine the appropriate reporting category.

See page IV-4 and IV-5 of the Federal Reserve's *Reserve Maintenance Manual* at https://www.federalreserve.gov/monetarypolicy/reserve-maintenance-manual-about-this-manual.htm.

Annual Panel Determinations

Each year the Federal Reserve reviews the institutions in the four reporting categories, and reassignments of institutions ("panel shifts") are determined each July and become effective in September. The panel shifts reflect movements in each individual depository institution's total deposits or total reservable liabilities across the prevailing boundaries (the exemption amount and the deposit cutoff) that separate the reporting categories. Documentation is available on the Federal Reserve's procedures (including the reports, data items, and reporting periods) for measuring an institution's total reservable liabilities and total deposits against the prevailing cutoffs for the annual panel determinations. Two special types of panel shifts are described below.

- *Voluntary shifts.* In July, the Federal Reserve informs each institution of its particular reporting requirement effective for September of that year to September of the following year. Any depository institution assigned to one particular category may elect instead to report deposits (and, if appropriate, to maintain reserves) in accordance with a higher-level category. (For example, an institution assigned to the FR 2900 quarterly reporting category may elect instead to report the FR 2900 weekly.) However, any such voluntary shifts may take place only once a year during the normal September panel shifts. Voluntary shifts to a lower-level category are not permitted.

- *Fast-growing institutions.* The Federal Reserve may require a depository institution that is experiencing above-normal growth to report on a more detailed or frequent basis before the September panel shifts.

For more detailed information, see the Federal Reserve's "Reserve Maintenance Manual."

REPORTS REQUIRED UNDER REGULATION H AND THE SECURITIES EXCHANGE ACT OF 1934

Section 12(i) of the Securities Exchange Act of 1934 (the 1934 act), as amended by the Sarbanes-Oxley Act of 2002, vests the Board with the authority to administer and enforce certain provisions of the 1934 act and the Sarbanes-Oxley Act with respect to state member banks that have a class of securities registered under section 12(b) or 12(g) of the 1934 act (registered state member banks). In particular, the Board is charged with enforcing sections 12, 13, 14(a), 14(c), 14(d), 14(f), and 16 of the 1934 act and sections 301, 302, 303, 304, 306(a), 401(b), 404, 406, and 407 of the Sarbanes-Oxley Act[2] with

2. See 15 USC 78j-1, 78*l*–78n, 78p, 7241–7244(a), 7261(b), 7262, 7264, and 7265.

respect to registered state member banks. Section 208.36(a) of Regulation H, which implements these provisions, generally requires registered state member banks to comply with any rules, regulations, and reporting forms adopted by the Securities and Exchange Commission (SEC) under the above-listed sections of the 1934 act and the Sarbanes-Oxley Act. (See 12 CFR 208.36(a), as amended by 68 *Fed. Reg.* 4096 (January 28, 2003).) Registered state member banks, however, generally must file any forms or reports required by these rules with the Board, rather than the SEC.

If a state member bank has a class of securities registered under section 12 of the 1934 act and, thus, is a registered state member bank, the examiner should consult with the bank's management to ensure that the reports required by Regulation H are properly filed with the Board. Listed below are a few of the most common forms and reports that must be filed with the Board by a registered state member bank pursuant to Regulation H. This list, however, is not exclusive and examiners should consult Board staff or Regulation H, the 1934 act, the Sarbanes-Oxley Act, and the SEC's implementing rules if questions arise concerning the filing of reports by a registered state member bank. See the list of reporting forms and the individual reporting forms and instructions on the SEC's website: www.sec.gov.

Section 12 of the 1934 Act

Form 8-A is for the registration of certain classes of securities pursuant to sections 12(b) or 12(g) of the 1934 act for, among other things, listing on national securities exchanges. Form F-10 is the general reporting form for registration of securities pursuant to the 1933 act and sections 12(b) or 12(g) of the 1934 act for classes of securities of issuers for which no other reporting form is prescribed.

Section 13 of the 1934 Act

Form 8-K must be filed within 4 business days after the occurrence of the earliest of one or more specified events that are required to be reported and that affect the bank or its operations, such as changes in control of registrant or an acquisition or disposition of a significant amount of assets. See the "Information to be Included in the Report" within the report instructions. Form 10-Q is for quarterly and transition reports and must be filed within 40 days for large accelerated filers; accelerated filers; or for others, 45 days after the end of each of the first three fiscal quarters. Form 10-K is for annual and transition reports that must be filed within 60 to 90 calendar days after the end of the registrant's fiscal year.

Section 16 of the 1934 Act

Section 16 requires the directors, officers, and principal shareholders of public companies to file reports concerning the purchase and sale of the company's equity securities. Form 3 collects the insider's initial beneficial ownership of registered companies, including banks. Form 4 collects changes in the insider's beneficial ownership. Form 5 is an annual statement of changes in beneficial ownership of securities.

Sarbanes-Oxley Act

The Sarbanes-Oxley Act[3] (the act) and the SEC's implementing rules require the principal executive officer and principal financial officer of public companies to file certain certifications with the company's annual 10-K report and quarterly 10-Q reports. The certifications must, among other things, state that the officer has reviewed the report, indicate that the report (to the officer's knowledge) does not contain any material misstatements or omissions, and contain certain representations concerning the company's internal controls.

The act requires the annual 10-K report of public companies to include a statement of management's responsibility for maintaining adequate internal-control structures and procedures for financial reporting and to contain an assessment of the effectiveness of these controls and procedures.[4] The company's external auditor must attest to, and report on, management's assessment. These reports and attestations are similar to the internal-control reports and attestations required by section 36 of the Federal Deposit Insurance Act (12 USC 1831m) for

3. See 15 USC 7241 (section 302 of the act).
4. See 15 USC 7262 (section 404 of the act).

insured depository institutions with total assets of $500 million or more.

The act[5] and the SEC's rules also require public companies to disclose in their periodic reports whether the company has adopted a code of ethics for its senior financial officers and whether the company's audit committee includes a "financial expert." If the company has not adopted a code of ethics or does not have a financial expert on its audit committee, the company must explain the reasons why not.

REPORTING AND INQUIRY REQUIREMENTS FOR LOST AND STOLEN SECURITIES

Every national securities exchange member, registered securities association member, broker, dealer, municipal securities dealer, government securities broker or dealer, registered transfer agent, and registered clearing agency and its participants, as well as every member bank of the Federal Reserve System and every bank whose deposits are insured by the Federal Deposit Insurance Corporation (reporting institutions), must register with the SEC's designee, the Securities Information Center, Inc. (SIC). All lost, missing, stolen, or counterfeit securities must be reported to the SIC. Except in certain limited circumstances, each insured bank is responsible for contacting the SIC to determine if the securities coming into its possession, whether by pledge, transfer, or some other manner, have been previously reported as missing, lost, stolen, or counterfeit.

All functions within a bank that handle or process securities are subject to the *reporting* requirements. Only the transfer-agent function is exempt from the *inquiry* requirements. Accordingly, all bank departments likely to be affected, including the trust, investment, transfer-agent, custody, or dealer departments, and the lending operations as relating to collateral loans, should be familiar with the requirements set out in 17 CFR 240.17f-1. Securities exempt from the reporting requirements are—

- registered U.S. Treasury securities of the U.S. government and federal agencies thereof,
- securities that have not been assigned CUSIP numbers, and
- bond coupons
- global securities
- uncertified securities, and
- any securities issue for which there is neither a record nor beneficial owners that can obtain negotiable securities certificates.

Securities exempt from the inquiry requirements are—

- securities received directly from the issuer or its agent at issuance,
- securities received from another reporting institution or from a Federal Reserve Bank or Branch,
- securities received from a customer of the reporting institution in the name of the customer or nominee, and
- securities that are a part of a transaction of $10,000 or less (aggregate face value for bonds or market value for stocks).

Lost, Missing, Stolen, or Counterfeit Securities

Form X-17F-1A must be filed with the SIC within one business day after the discovery of—

- a theft or loss of any security when there is a substantial indication of criminal activity,
- a security that has been lost or missing for two business days when criminal actions are not suspected, and
- a security that is counterfeit.

The reporting form must be filed within two business days of notification of nonreceipt when delivery of securities sent by the bank—

- is made by mail or draft and payment is not received within 10 business days, and confirmation of nondelivery has been made by the receiving institution; and
- is in person and no receipt is maintained by the bank.

If securities sent by the bank, either in person or through a clearing agency, are lost in transit and the certificate numbers of the securities can be determined, the bank (delivering institution) must report the certificate numbers of the secu-

5. See 15 USC 7264–7265 (sections 406 and 407 of the act).

rities within two business days after notice of non-receipt or as soon as the certificate numbers of the securities can be ascertained.

When a shipment of retired securities certificates is in transit between any unaffiliated transfer agents, banks, brokers, dealers, or other reporting institutions, and the delivering institution fails to receive notice of receipt or non-receipt of the certificates, the delivering institution is required to act to determine the facts. When the certificates are not recovered by the delivering institution, the delivering institution must report the certificates as lost, stolen, or missing within a reasonable time period, but in any event within twenty business days from the date of shipment. The delivery of lost or missing securities to the bank must be reported within one business day after discovery and notification of certificate numbers. Securities that are considered lost or missing as a result of count or verifications must be reported no later than 10 business days after discovery or as soon as certificate numbers can be ascertained.

Copies of all reports required to be filed under 17 CFR 240.17f-1 must also be submitted to the registered transfer agent for the issue being reported and, if criminal activities are suspected, to the Federal Bureau of Investigation. Copies of filed or received Forms X-17F-1A must be maintained in an easily accessible place for three years.

TRANSFER-AGENT ACTIVITIES

If a bank acts as a transfer agent for its own stock, the stock of its holding company, or any other equity security, it may have to register with the Board as a transfer agent pursuant to the requirements of Regulation H (section 208.31). State member bank transfer agents must comply with the SEC's rules prescribing operational and reporting requirements, which the SEC adopted pursuant to section 17A(2) of the 1934 act (15 USC 78q-1). For member banks, see 17 CFR 240.17Ac2 (1-2) and 240.17Ad-1-240.17Ad-16). (See section 208.31(b) of Regulation H.) Any entity performing transfer agent functions for a security is required to register if the security is registered on a national securities exchange and if the issuer has total assets of $10 million and a class of equity security held on record by 500 or more persons. The registrations are public filings and are *not* confidential.

The interagency Transfer Agent Registration and Amendment Form, Form TA-1, is used by member banks and other entities to register before becoming, and then to act as, a transfer agent. They also use the reporting form to amend registration information as necessary. The information collected includes the company name, all business addresses, and information about the registrant's proposed activities as a transfer agent.

The Federal Reserve uses the information to act upon registration applications and to aid in performing supervisory duties. The Federal Reserve forwards copies of the completed registration forms to the Securities and Exchange Commission, which maintains registration data to aid in its statutory mandate to develop rules and standards applicable to all registered transfer agents.

Municipal Securities Dealer Activities

A state member bank, subsidiary, department, or division thereof that is a municipal securities dealer must register and file amendments with both the SEC and the Federal Reserve Board Board as a municipal securities dealer by filing the SEC's Form MSD, pursuant to Section 15 B(a) of the Securities Exchange Act of 1934 and the SEC's rule 15Ba2-1. A discussion of the bank's responsibilities as a municipal securities dealer, filing requirements, and other information, including examination procedures, are discussed in section 2030.1. A notice of withdrawal from registration as a municipal securities dealer pursuant to section 15B(c) must be filed with the SEC and the Board on the SEC's Form MSDW when the municipal securities dealer is a bank, or a separately identifiable department or division of a bank.

Government Securities Broker and Dealer Activities

If a state member bank, a foreign bank, a state branch or an agency of a foreign bank, or a commercial lending company owned or controlled by a foreign bank acts as a government securities broker or dealer, it may have to file notice with the Board as a government securities broker or dealer by filing FR G-FIN, pursuant to section 15C(a)(1)(B) of the Securities and

Exchange Act of 1934. This notice collects the institution's identifying information and the names and titles of its managers of government securities activities; the notice requires the institution to state whether any person associated with the respondent's government securities activities has been involved in disciplinary proceedings related to securities sales. When such a financial institution intends to cease engaging in broker or dealer activities, it must notify its regulator by using the Notice by Financial Institutions of Termination of Activities as a Government Securities Broker or Government Securities Dealer (FR G-FINW). A discussion of the bank's responsibilities as a government securities broker or dealer, filing requirements, and other information, including examination procedures, are discussed in SR-87-37, as amended. See also SR-94-5, 93-40, 90-1, and 88-26. The Board has also developed a Summary Report of Government Securities Broker/Dealer Activities (GSB-D report).

INTERNATIONAL ACTIVITIES

A bank must file certain reports if it is conducting or intends to conduct international activities through either foreign branches or Edge Act or agreement corporations. Listed below is a brief description of each of these reports.

FFIEC 009—Country Exposure Report

FFIEC 009 is filed quarterly by all U.S. banks and bank holding companies that meet certain ownership criteria and that, on a fully consolidated basis, have total outstanding claims of $30 million or more (or equivalent) on foreign residents of the U.S. Information is collected on the distribution by country of these foreign claims on foreigners held by U.S. banks and bank holding companies.

FFIEC 009a—Country Exposure Information Report

FFIEC 009a is a quarterly supplement to the Country Exposure Report (FFIEC 009) that provides specific information about the reporting institution's exposures in particular countries of U.S. banking institutions. Part A must be filed when exposure to a single country exceeds 1 percent of the banking institution's total assets or 20 percent of that institution's capital, whichever is less. Part B provides a list of countries where exposures were between 0.75 percent and 1 percent of the respondent's assets or between 15 percent and 20 percent of capital.

FFIEC 030/FFIEC 030S—Foreign Branch Report of Condition/Abbreviated Foreign Branch Report of Condition

These reports collect information on the structure and geographic distribution of foreign branch assets, liabilities, derivatives, and off-balance-sheet data of foreign branches of insured U.S.-chartered commercial banks. For purposes of this report, branches in Puerto Rico and other U.S. territories and possessions are considered foreign branches. Participation in the completion and submittal of the reports is mandatory.

The FFIEC 030 is filed quarterly for significant branches, with either $2 billion or commitments to purchase foreign currencies and U.S. dollar exchange of at least $5 billion. It is filed annually for other branches with total assets in excess of $250 million. The Federal Reserve uses the data to plan examinations and to analyze the foreign operations of domestic banks. Growth trends can be measured by bank, by country, and by bank within country. Aggregate data are a useful source of information on bank activities.

The FFIEC 030S collects financial data items for smaller, less-complex branches. It is filed annually, as of December 31, for foreign branches that do not meet the criteria to file the FFIEC 030 but have total assets of $50 million or more (but less than or equal to $250 million).

FR 2064—Recordkeeping Requirements

Effective September 1, 2001, the FR 2064 reporting form was replaced with a recordkeeping requirement and certain structure information was moved to the FR Y-10, Report of Changes in Organizational Structure. Internationally active U.S. banking organizations are still expected to maintain adequate internal records to allow examiners to review compliance with the investment provisions of Regulation K, under the recordkeeping requirements of FR 2064 (no form is associated with this recordkeeping requirement). For each investment made under subpart A of Regulation K, records should be maintained on the type of investment (for example, equity (voting shares, nonvoting shares, partnerships, interests conferring ownership rights, participating loans)), binding commitments, capital contributions, and subordinated debt), the amount of the investment, the percentage ownership, activities conducted by the company and the legal authority for such activities, and whether the investment was made under general-consent, prior-notice, or specific-consent authority. For those investments made under general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in sections 211.8 and 211.10 of Regulation K.

Information maintained by the banking organization should be made available to examination staff during the course of on-site examinations and pursuant to other supervisory requests. The recordkeeping must be adequate to permit examiners to determine compliance. Examiners are expected to review a sample of these investments to determine the accuracy of the organization's records and to determine compliance with the regulation. (See SR-02-2.)

FR 2314/FR 2314S—Financial Statements of Foreign Subsidiaries of U.S. Banking Organizations

The FR 2314 is reported quarterly or annually, as of the last calendar day of the quarter, based on certain threshold criteria. The FR 2314 collects selected financial information for direct or indirect foreign subsidiaries of U.S. state member banks, Edge and agreement corporations, and bank holding companies. The FR 2314 consists of a balance sheet and income statement; information on changes in equity capital, changes in the allowance for loan and lease losses, off-balance-sheet items, and loans; and a memoranda section. The FR 2314S should be filed annually as of December 31 and collects four financial data items for smaller, less complex subsidiaries.

FR 2502q—Quarterly Report of Assets and Liabilities of Large Foreign Offices of U.S. Banks

The FR 2502q report is to be submitted by U.S. head offices of bank holding companies, commercial banks, and Edge and agreement corporations that file for their major foreign branches and large banking subsidiaries. It provides a geographic breakdown of each office's assets and liabilities. Branches of a U.S. bank with $500 million or more in total assets and foreign banking subsidiaries with $2 billion or more in total assets, or $10 million in deposit liabilities, are required to file this report quarterly.

FR 2886b—Consolidated Report of Condition and Income for Edge Act and Agreement Corporations

FR 2886b covers the operations of the reporting corporation, including any international banking facilities of the reporter. Corporations engaged in banking must submit the data at least quarterly.

FR 2915—Report of Foreign Currency Deposits

FR 2915 collects seven-day averages of the amounts outstanding of foreign currency–denominated deposits held at U.S. offices of the depository institution, converted to U.S. dollars and included in the Report of Transaction Accounts, Other Deposits and Vault Cash (FR 2900). The report is collected with the reporting week that begins the third Tuesday of March, June, September, and December.

FR Y-10—Report of Changes in Organizational Structure

The Y-10 is used to report, among other things, information on worldwide organizational structure of bank holding companies (BHCs), member banks, Edge and agreement corporations, and the U.S. operations of foreign banking organizations (FBOs)[6]. The reporting form

6. An FBO with U.S. operations that is not or ceases to be a "qualifying foreign banking organization" (QFBO) within

includes detailed information on the structure of top-tier BHCs organized under U.S. or foreign law that are not FBOs, regardless of financial holding company (FHC) status; FBOs (both qualifying and nonqualifying) whether or not a BHC; state member banks not controlled by a BHC or FBO; Edge and agreement corporations not controlled by a BHC, FBO, or member bank; and nationally chartered banks not controlled by a BHC or FBO, but only with respect to their foreign investments. Within 30 calendar days of the event, banking organizations are required to report changes in investments as well as new activities (both foreign and domestic) on the FR Y-10 report. The reporting form includes the structure information on changes in FBOs (formerly the FR Y-10F) and the change in status of foreign branch of U.S. banking organizations (formerly the FR 2058).

The Board has placed greater importance on monitoring the level of international investments to ensure compliance with relevant banking laws and regulations, and to ensure that banking organizations do not expose themselves to undue risk. Examiners and other Federal Reserve System staff have a continuing need to monitor compliance with the Federal Reserve Act and sections 211.8–211.10 of the revised Regulation K.

Investments of less than 25 percent of the voting shares of a foreign nonbanking company are reported on the FR Y-10.[7] However, using the FR Y-6 (Annual Report of Bank Holding Companies) and the FR Y-7 report (Annual Report of Foreign Banking Organizations), banking organizations are required to report annually all investments, including those between 5 percent and 25 percent of voting shares.[8] The FR Y-6, FR Y-7, and the FR Y-10 collect information on structure and geographical information relating to foreign investments for ongoing monitoring.

the meaning of Regulation K, and is not otherwise treated as a QFBO under Regulation K, should consult with Federal Reserve staff regarding the scope of its reporting obligations. In general, an FBO that is not or is not treated as a QFBO is subject to the nonbanking restrictions of the BHC Act with respect to its worldwide operations and, thus, would have to report on the FR Y-10 changes to its worldwide organizational structure.

7. Regulation K authorizes portfolio investments in less than 20 percent of the shares of a foreign company regardless of the activities engaged in by that company. Portfolio investments within the general-consent limits are required to be reported annually on the FR Y-6.

8. Investments representing less than 5 percent ownership are not required to be reported.

Examiners are expected to review investment amounts and activities during the examination process. The portion of an examination dealing with Regulation K compliance should focus on confirming investments made pursuant to the general-consent provisions to meet the restrictions on investment amount and activities in sections 211.8–211.10 of Regulation K. Investments made under the general-consent provisions of Regulation K can be sizable, and thus can pose significant risk to the banking organization. Examiners should keep in mind that the Board has the authority to rescind an organization's general-consent investment privileges for various reasons, including safety-and-soundness concerns and noncompliance with the existing requirements of Regulation K. (See SR-02-2.)

Treasury International Capital Forms

The following reports are collected to gather information on international capital movements by U.S. banks and their Edge Act and agreement corporations, other depository institutions, international banking facilities, and bank holding companies.

- BC: Report of U.S. Dollar Claims of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers on Foreigners
- BL-1: Report of U.S. Dollar Liabilities of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers to Foreign-Residents
- BL-2: Report of Customers' U.S. Dollar Liabilities to Foreigners
- BQ-1: Report of Customers' U.S. Dollar Claims on Foreigners
- BQ-2: Part 1. Report of Foreign Currency Liabilities and Claims of Depository Institutions, Bank Holding Companies/ Financial Holding Companies, Brokers and Dealers, and of Their Domestic Customers vis-à-vis Foreigners
- BQ-2: Part 2. Report of Customers' Foreign Currency Liabilities to Foreigners
- BQ-3: Report of Maturities of Selected Liabilities of Depository Institutions, Bank Holding Companies/Financial Holding Companies, Brokers, and Dealers to Foreigners

D: Report of Holdings of, and Transactions in, Financial Derivatives Contracts

S: Purchases and Sales of Long-Term Securities by Foreign-Residents

SHC/SHCA: Report of U.S. Ownership of Foreign Securities, Including Selected Money Market Instruments

SHL/SHLA: Foreign-Residents' Holdings of U.S. Securities, Including Selected Money Market Instruments

Consolidated Foreign Currency Reports of Major Market Participants

The Treasury Foreign Currency (TFC) Report of major market participants collects data on the foreign exchange contracts and actively manages positions of major nonbank market participants. This report is collected and processed by the Federal Reserve System, acting as fiscal agent for the Department of the Treasury. These data are designed to assess and monitor the foreign exchange developments in the spot, forward, futures, and options markets on an individual and aggregate basis. The TFC series is comprised of three reports: (1) the Weekly Consolidated Foreign Currency Report of Major Market Participants (TFC-1), (2) the Monthly Consolidated Foreign Currency Report of Major Market Participants (TFC-2), and (3) the Quarterly Consolidated Foreign Currency Report (TFC-3).

Key Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC)® References

In June 2009, the FASB issued Statement No. 168, The FASB Accounting Standards Codification® and the Hierarchy of Generally Accepted Accounting Principles (FAS 168), to establish the FASB Codification as the single source of authoritative nongovernmental U.S. generally accepted accounting principles. The FASB Codification is effective for interim and annual periods ending after September 15, 2009. The following table is largely applicable to Call Reports and other regulatory reports, which are discussed in more detail in section 4150 of this manual. The table can also be used for precodification FASB references that are found throughout the *Commercial Bank Examination Manual*. More information regarding the FASB ASC Codification can be accessed at http://asc.fasb.org/.

Precodification Reference/Description			*Codification Topic*	*Codification Subtopic*
SFAS	5	Accounting for Contingencies	310 Receivables	10 Overall
			450 Contingencies	20 Loss Contingencies
SFAS	13	Accounting for Leases	840 Leases	
SFAS	15	Accounting for Debtors and Creditors for Troubled Debt Restructurings	310 Receivables	40 Troubled Debt Restructurings by Creditors
SFAS	28	Accounting for Sales with Leasebacks	840 Leases	40 Sale-Leaseback Transactions
SFAS	34	Capitalization of Interest Costs	835 Interest	20 Capitalization of Interest
SFAS	52	Foreign Currency Translation	830 Foreign Currency Matters	

Precodification Reference/Description			*Codification Topic*		*Codification Subtopic*	
SFAS	65	Accounting for Certain Mortgage Banking Activities (as amended by SFAS 140)	948	Financial Services – Mortgage Banking		
SFAS	66	Accounting for Sales of Real Estate	360	Property, Plant, and Equipment	20	Real Estate Sales
SFAS	72	Accounting for Certain Acquisitions of Banking and Thrift Institutions	805	Business Combinations		
SFAS	86	Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed	985	Software	20	Costs of Software to Be Sold, Leased or Marketed
SFAS	87	Employer's Accounting for Pensions	715	Compensation – Retirement Benefits		
SFAS	91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases	310	Receivables	20	Nonrefundable Fees and Other Costs
SFAS	94	Consolidation of All Majority-owned Subsidiaries	810	Consolidation	10	Overall
SFAS	106	Employer's Accounting for Postretirement Benefits Other Than Pensions	715	Compensation – Retirement Benefits		
SFAS	109	Accounting for Income Taxes	740	Income Taxes		
SFAS	114	Accounting by Creditors for Impairment of a Loan	310	Receivables		
SFAS	115	Accounting for Certain Investments in Debt and Equity Securities	320	Investments – Debt and Equity Securities		
SFAS	125	Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (superseded by SFAS 140)	860	Transfers and Servicing		
SFAS	133	Accounting for Derivative Instruments and Hedging Activities (as amended by SFAS 149)	815	Derivatives and Hedging		
SFAS	140	Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (as amended by SFAS 166)	860 405	Transfers and Servicing Liabilities	 20	 Extinguishments of Liabilities
SFAS	141R	Business Combinations	805	Business Combinations		

Precodification	*Reference/Description*		*Codification Topic*		*Codification Subtopic*	
SFAS	142	Goodwill and Other Intangible Assets	350	Intangibles – Goodwill and Other		
SFAS	144	Accounting for the Impairment of Long-Lived Assets	360	Property, Plant, and Equipment		
SFAS	149	Amendment of Statement 133 on Derivative Instruments and Hedging Activities	815	Derivatives and Hedging	10	Overall
SFAS	154	Accounting Changes and Error Corrections	250	Accounting Changes and Error Corrections		
SFAS	155	Accounting for Certain Hybrid Financial Instruments	815	Derivatives and Hedging	15	Embedded Derivatives
SFAS	156	Accounting for Servicing of Financial Assets	860	Transfers and Servicing	50	Servicing Assets and Liabilities
SFAS	157	Fair Value Measurements	820	Fair Value Measurements and Disclosures		
SFAS	159	Fair Value Option	825	Financial Instruments	10	Overall
SFAS	166	Accounting for Transfers of Financial Assets	860	Transfers and Servicing	10	Overall
			320	Investments – Debt and Equity Securities		
SFAS	167	Amendments of FASB Interpretation No. 46(R)	810	Consolidation	10	Overall
DIG	Issue B40	Application of Paragraph 13(b) to Securitized Interests in Prepayable Financial Assets	815	Derivatives and Hedging	15	Embedded Derivatives
EITF	90-5	Exchanges of Ownership Interests between Entities under Common Control	852	Reorganizations	10	Overall
EITF	96-19	Debtor's Accounting for a Modification or Exchange of Debt Instruments	470	Debt	50	Modification and Extinguishments
EITF	99-20	Recognition of Interest Income and Impairment on Purchased and Retained Interests in Securitized Financial Assets	325	Investments – Other	40	Beneficial Interests in Securitized Financial Assets
EITF	03-16	Accounting for Investments in Limited Liability Companies	323	Investments – Equity Method and Joint Ventures	30	Partnerships, Joint Ventures and Limited Liability Entities

Precodification Reference/Description			*Codification Topic*		*Codification Subtopic*	
EITF	06-4	Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements	715	Compensation – Retirement Benefits	60	Defined Benefit Plans – Other Postretirement
EITF	06-5	Accounting for Purchases of Life Insurance – Determining the Amount That Could Be Realized in Accordance with FASB TB 85-4	325	Investments – Other	30	Investments in Insurance Contracts
EITF	06-10	Accounting for Deferred Compensation and Postretirement Benefit Aspects of Collateral Assignment Split-Dollar Life Insurance Arrangements	715	Compensation – Retirement Benefits	60	Defined Benefit Plans – Other Postretirement
EITF	Topic D-46	Accounting for Limited Partnership Investments	323	Investments – Equity Method and Joint Ventures	30	Partnerships, Joint Ventures and Limited Liability Entities
EITF	Topic D-97	Push-Down Accounting	805	Business Combinations	50	Related Issues
TB	85-4	Accounting for Purchases of Life Insurance	325	Investments – Other	30	Investments in Insurance Contracts
INT	14	Reasonable Estimation of the Amount of a Loss	450	Contingencies	20	Loss Contingencies
INT	39	Offsetting of Amounts Related to Certain Contracts	210	Balance Sheet	20	Offsetting
INT	41	Offsetting of Amounts Related to Certain Repurchases and Reverse Repurchase Agreements	210	Balance Sheet	20	Offsetting
INT	48	Accounting for Uncertainty in Income Taxes	740	Income Taxes	10	Overall
ARB	43	Chapter 1, Section B	505	Equity	30	Treasury Stock
APBO	12	Omnibus Opinion – 1967	710	Compensation-General	10	Overall
APBO	16	Business Combinations	805	Business Combinations		
APBO	17	Intangible Assets	350	Intangibles – Goodwill and Other		
APBO	20	Accounting Changes	250	Accounting Changes and Error Corrections		
APBO	21	Interest on Receivables and Payables	835	Interest	30	Imputation of Interest
APBO	25	Accounting for Stock Issued to Employees	718	Compensation – Stock Compensation		

Precodification Reference/Description			*Codification Topic*		*Codification Subtopic*	
APBO	30	Reporting the Results of Operations	225	Income Statement	20	Extraordinary and Unusual Items
PB	4	Accounting for Foreign Debt/Equity Swaps	942	Financial Services – Depository and Lending	310	Receivables
PB	6	Amortization of Discounts on Certain Acquired Loans*				
PB	11	Accounting for Preconfirmation Contingencies in Fresh-Start Reporting	852	Reorganizations	10	Overall
SOP	90-7	Financial Reporting by Entities in Reorganization Under the Bankruptcy Code	852	Reorganizations	10	Overall
SOP	92-3	Accounting for Foreclosed Assets (superseded by SFAS 144)*				
SOP	93-6	Employers' Accounting for Employee Stock Ownership Plans	718	Compensation – Stock Compensation	40	Employee Stock Ownership Plans
SOP	98-1	Accounting for the Costs of Computer Software Developed or Obtained for Internal Use	350	Intangibles – Goodwill and Other	40	Internal-Use Software
SOP	98-5	Reporting on the Costs of Start-Up Activities	720	Other Expenses	15	Start-Up Costs
SOP	03-3	Accounting for Certain Loans or Debt Securities Acquired in a Transfer	310	Receivables	30	Loans and Debt Securities Acquired with Deteriorated Credit Quality

Notes:
APBO Accounting Principles Board Opinion
ARB Accounting Research Bulletin
DIG Derivatives Implementation Group
EITF Emerging Issues Task Force
INT FASB Interpretation
PB AICPA Practice Bulletin
SFAS Statement of Financial Accounting Standards
SOP AICPA Statement of Position
TB FASB Technical Bulletin
* Precodification Standard referenced in the Call Report instructions, but not codified in the Accounting Standards Codification

Review of Regulatory Reports
Examination Objectives
Effective date May 1996

Section 4550.2

1. To determine that required reports are being filed on time.
2. To determine that the contents of reports are accurate.
3. To effect corrective action when official reporting, practices, policies, or procedures are deficient.

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
2. Determine the bank's historical record of submitting timely and accurate reports by reviewing workpapers and the Regulatory Reports Monitoring Program.
3. Instruct those examiners assigned specific departments that generate regulatory reports to:
   a. Determine from department records what regulatory reports should have been filed because of the passage of time or the occurrence of an event.
   b. Obtain copies of all regulatory reports filed by the department since the previous examination.
   c. Check the reports obtained in the preceding step and the date of filing against statutory and regulatory requirements.
   d. Instruct the bank to prepare and submit any delinquent reports.
   e. For the most recent filing of those reports submitted on a periodic basis and all other reports submitted since the last examination, perform the following:
      - Reconcile the line items shown on the reports to the bank's general ledger, subsidiary ledgers, or daily statements.
      - Obtain the bank's workpapers applicable to each line item and reconcile individual items to the reports.
      - Determine whether other examining personnel uncovered any misstatement of assets, liabilities, income, or expense during their examination of the various departments.
      - Determine that the reports are prepared in accordance with Federal Reserve and/or other applicable instructions.
   f. On the basis of the work performed in the preceding step, perform either of the following, as appropriate:
      - If the reports are found to be substantially correct, limit the review of the remaining periodic reports filed since the last examination to the reconciliation of financial statement account categories to general ledger control accounts.
      - If the reports are found to be substantially incorrect, extend the procedures outlined in step 3.e to the remaining periodic reports filed since the last examination for those areas where items were found to be substantially incorrect.
   g. Scan all periodic reports for unusual fluctuations. Investigate fluctuations, if any.
4. Review compliance with the missing, lost, counterfeit, or stolen securities requirements of 17 CFR 240.17f-1 by:
   a. Discussing with appropriate officers and personnel the procedures in effect regarding the filing of Form X-17F-1A (Missing, Lost, Stolen, or Counterfeit Securities Report).
   b. Discussing with the appropriate persons the procedures in effect regarding compliance with the inquiry requirements.
   c. Substantiating Internal Control questions 6 through 15, as appropriate.
5. Prepare comments in appropriate report form and discuss with management:
   a. Violations of law or regulations.
   b. Inaccurate reports, and, if applicable, the need for amended reports. If amended reports are considered appropriate, consult with Reserve Bank supervisory personnel before requesting the bank to refile the report(s).
   c. Material differences in the annual report of the state member bank whose securities are subject to registration pursuant to the Securities Exchange Act of 1934. (State law governs the furnishing of annual reports to stockholders for banks with less than 500 shareholders.)
   d. Recommended corrective action when policies, practices, or procedures are deficient or when reports have been filed incorrectly, late, or not at all.

   The comments must include, if applicable, the name(s) and the "as of" date(s) of amended report(s); and the date of filing, amount of, and explanation of any material difference existing in either the numerical items or narrative statements in the annual report.
6. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures for regulatory reports. 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.

1. Do requests for all regulatory reports come to one individual or department?
2. Does that individual or department have the authority to request that required information be prepared by the applicable banking department?
3. To ensure that all regulatory reports are submitted on a timely basis and are accurate, determine the following:
   a. If completion of the report requires information from several departments:
      - Is a written memorandum sent to the various departments requesting the information?
      - Is the memorandum addressed to a department head?
      - Does the memorandum have a due date?
      - Are procedures in effect to send second requests if the memorandum is not returned by its original due date?
      - Does completion of the memorandum require two signatures, that of the person gathering the information and that of the person's superior who is held responsible for its accuracy?

   b. If completion of the report requires information from one department, is there separation of duties to ensure that the raw data to complete the report is compiled by one person and verified by another person, prior to submission?
4. After the report is prepared, but prior to its submission, is it checked by:
   a. The supervisor of the department preparing the report, who takes personal responsibility for its accuracy and submission on a timely basis?
   b. Bank personnel who have no part in the report's preparation?
5. Do report workpapers leave a clear audit trail from the raw data to the finished report and are they readily available for inspection?

Review the bank's system for compliance with the reporting and inquiry requirements of the lost and stolen securities provisions of 17 CFR 240.17f-1.

6. Has the bank registered as a direct or indirect inquirer with the Securities Information Center, Inc.?
7. Are reports submitted within one business day of discovery when:
   a. Theft or loss of a security is believed to have occurred through criminal activity?
   b. A security has been missing or lost for two business days, except in certain cases?
   c. A security is counterfeit?
8. Are reports submitted by the bank, as a delivering institution, within two business days of notification of nonreceipt when:
   a. Delivery is in person and no receipt is maintained by the bank?
   b. Delivery of securities is made by mail or via draft, and payment is not received within 10 business days and confirmation of nondelivery has been made by the receiving institution?
   c. Securities are lost in transit and the certificate number(s) can be determined?
9. Are reports submitted by the bank, as a receiving institution, within one business day of discovery and notification of the certificate number(s) when:
   a. Securities are delivered through a clearing agency and the delivering institution has supplied the certificate numbers within the required two business days after request?
   b. Securities are delivered over the window and the delivering institution has a receipt and supplies the certificate number(s) within the required two business days after request?
10. Are securities that are considered to be lost or missing as a result of counts or verifications reported no later than ten business days after discovery or as soon after as the certificate number(s) can be ascertained?
11. Are copies of those reports submitted to the registered transfer agent for the issue and, in

the case of suspected criminal activity, the Federal Bureau of Investigation?

12. Are all recoveries of securities reported within one business day of recovery or finding? (Note: Only the institution that initially reported the security as missing can make a recovery report.)
13. Are inquiries made when the bank takes in any security that is not:
    a. Received directly from the issuer or issuing agent at issuance?
    b. Received from another reporting institution or Federal Reserve bank in its capacity as fiscal agent?
    c. Received from a bank customer and is registered in the name of the customer or its nominee?
14. Are all reports made on Form X-17F-1A or facsimile?
15. Are copies of Form X-17F-1A and subsequent confirmations and other information received maintained for three years in an easily accessible location?

CONCLUSION

16. Does the foregoing information provide an adequate basis for evaluating internal controls 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.
17. Are internal controls adequate based on a composite evaluation, as evidenced by answers to the foregoing questions?

To meet competitive pressures, banks provide a large number of customer services that normally do not result in assets and liabilities subject to entry on the general ledger, but that may involve significant risk. These customer services include fiduciary accounts, investment management, customer safekeeping, rental of safe deposit box facilities, purchase and sale of investments for customers, sale of traveler's checks, and collection department services. The bank is responsible for properly maintaining and safeguarding all consigned items. Banks accomplish the necessary control and review of consigned and collection items through non-ledger control or memorandum accounts. Automated systems, such as a Securities Movements Accounting and Control system (SMAC), can provide proper control for fiduciary, customer safekeeping, custodial, and investment management accounts.

CUSTOMER SAFEKEEPING

Custodial and Investment Management Accounts

Banks may act as custodians for customers' investments such as stocks, bonds, or gold. Custodial responsibilities may involve simple physical storage of the investments, as well as recording sales, purchases, dividends, and interest.[1] On the other hand, responsibilities may be expanded to include actually managing the account. This type of account management includes advising customers when to sell or buy certain investments, as well as meeting their recording requirements. In addition, the bank may lend securities from custodial accounts if authorized by the customer. This transaction allows the bank, as custodian, to charge a fee for lending the securities, thereby reducing its net custody costs. Also, both the bank and the custodial account benefit from interest earned on the transaction. This type of transaction should be governed by a policy that clearly specifies quality and maturity parameters. Additionally, to prevent defaults, borrowers should be subject to minimum credit standards, ongoing financial monitoring, and aggregate borrowing limits. Banks may also indemnify customer accounts against losses from a borrower or collateral default. Such indemnification creates a contingent financial risk to the institution.

Before providing such management and/or lending services, the bank should seek the advice of legal counsel about applicable state and federal laws concerning that type of bank-customer relationship. In addition, the use of signed agreements or contracts that clearly define the services to be performed by the bank is a vitally important first step in limiting the bank's potential liability and risk. The bank must also ensure that a proper control environment, including joint custody and access procedures, is established and maintained in support of custodial and management activities. Clearly, the largest and most active companies take on an increased level of risk. For companies that are aggressively pursuing custodial services or other nontraditional lines of business, the examiner should consider an expanded scope of review for these activities.

Safe Deposit Boxes

When banks maintain safe deposit box facilities, the bank and the customer enter into a contract whereby the bank receives a fee for renting safe deposit boxes. The bank assumes the responsibility of exercising reasonable care and precaution against loss of the box's contents. When a loss does occur, unless the bank can demonstrate it has maintained the required standard of care, it could be held liable for the loss. The required standard of care is defined as that which would be taken by a reasonably prudent and careful person engaged in the same business. Two different keys are required to open the box, and the customer and the bank each have one. Careful verification of a customer's identification is critical to meeting an appropriate standard of care. The customer is not required to disclose the contents of the box to the bank and upon court order the bank may gain access to the box without the presence of the customer.

1. Collection of interest and dividend income cannot be facilitated by the bank where the securities held are still in the customer's name, unless the paying agent is advised to change the dividend/interest address. Typically, when securities remain in the registered name of the holder, the holder continues to receive the dividend/interest payments. If the securities are re-registered into the name of the bank (or its nominee), then dividends and interest are received by the bank for the credit of the custodial customer.

Safekeeping

In addition to items held as collateral for loans, banks occasionally hold customers' valuables for short periods of time. The bank may or may not charge a fee for the service. Although it is a convenience for bank customers, many banks attempt to discourage the practice by emphasizing the benefits of a safe deposit box. When it is not possible or practical to discourage a customer, the same procedures that are employed in handling collateral must be followed. Items to be stored should be inventoried by two persons and maintained under dual control in the bank's vault. A multicopy, prenumbered, safekeeping receipt should be prepared with a detailed description of the items accepted and it should be signed by the customer. Sealed packages with contents unknown to the bank should never be accepted for safekeeping.

COLLECTION ITEMS

The collection department is one of the most diversified areas in the bank. It engages in receiving, collecting, and liquidating items which generally require special handling and for which credit normally is given only after final payment is received. The bank acts as agent for its customers or correspondents and receives a fee for that service. Even though general ledger accounts rarely are used in the collection process, the importance and value of customer assets under bank control demand the use of accounting procedures adequate to provide a step-by-step historical summary of each item processed. An audit trail must be developed to substantiate the proper handling of all items and to reduce the bank's potential liability.

CONSIGNED ITEMS

The most common items held on consignment by banks are unissued gift or traveler's checks; commemorative coins, postage stamps, and other consigned or promotional assets; and gold. Traveler's checks may be useful to customers because of the possibility that customers can obtain a refund if the checks are lost or stolen. Traveler's checks are issued for a fee or commission shared by the consignor and the issuing bank. Generally, a working supply of the checks is maintained at the teller line or selling station and a reserve supply is maintained under dual control in the bank's vault.

Under paragraph 7 of section 5136 of the Revised Statutes, national banks may exercise their powers "by buying and selling exchange, coin and bullion." This statute is applied to state member banks under section 9, paragraph 20, of the Federal Reserve Act. Consequently, banks may deal only in gold or silver that qualifies as coin or bullion. The term "coin" means coins minted by a government or exact restrikes, minted at a later date by, or under the authority of, the issuing government.

Rarely does a bank receive sufficient revenues from the above transactions to cover the cost of handling them. However, banks must offer a full range of services to be competitive and attract customers. The bank assumes the responsibility and related contingent liability to properly maintain the assets of others and to properly record all transactions involved with the consigned items.

INTERNAL CONTROL CONSIDERATIONS

It is essential that bank policy provides for proper internal controls, operating procedures, and safeguards. In all cases, control totals must be generated and the function balanced periodically by someone not associated with the function. Proper insurance protection must also be obtained to protect against claims arising from mishandling, negligence, mysterious disappearance, or other unforeseen occurrences. If an employee should, by fraud or negligence, permit unauthorized removal of items held for safekeeping or issue traveler's checks improperly, the bank may be held liable for losses. Therefore, banks should maintain adequate bonding for contingent liabilities and the examiner should review applicable insurance policies.

Other Non-Ledger Control Accounts

Examination Objectives

Effective date May 1996

Section 4560.2

1. To determine if the policies, practices, procedures, and internal controls regarding custodial activities, consigned items, and other non-ledger control accounts are adequate.
2. To determine if bank officers and employees 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 Consigned Items and Other Non-Ledger Control Accounts section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by 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. Obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned ‘‘Internal Control’’ and determine if appropriate corrections have been made.
4. Obtain a listing of consigned items or assets, payment instruments, and other non-ledger control accounts from the bank.
5. Scan any existing control accounts for any significant fluctuations and determine the cause of fluctuations.
6. Compare bank control records to remittance records for unissued U.S. savings bonds and state-issued food stamp value-payment cards or instruments.
7. Determine compliance with laws and regulations pertaining to non-ledger control accounts by determining, through observation and discussion with management, that there exist no violation of the prohibition against a bank participating in lotteries (section 9A of the Federal Reserve Act (12 USC 25A)).
8. Prepare in appropriate report form, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Recommended corrective action when policies, practices or procedures are deficient.
9. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for consigned items and other non-ledger items. 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.

SAFE DEPOSIT BOXES

1. Has counsel reviewed and approved the lease contract in use which covers the rental, use and termination of safe deposit boxes?
*2. Is a signed lease contract on file for each safe deposit box in use?
3. Are receipts for keys to the safe deposit box obtained?
4. Are officers or employees of the bank prohibited from acting as a deputy or having the right of access to safe deposit boxes except their own or one rented in the name of a member of their family?
5. Is the guard key to safe deposit boxes maintained under absolute bank control?
6. Does the bank refuse to hold, for renters, any safe deposit box keys?
7. Is each admittance slip signed in the presence of the safe deposit clerk and the time and date of entry noted?
8. Are admittance slips filed numerically?
9. Are vault records noted for joint tenancies and co-rental contracts requiring the presence of two or more persons at each access?
10. Are the safe deposit boxes locked closed when permitting access and the renter's key removed and returned to the customer?
11. Is the safe deposit clerk prohibited from assisting the customer in looking through the contents of a box?
12. Does the safe deposit clerk witness the relocking of the box?
13. Are all coupon booths examined by an attendant after being used but before being assigned to another renter, to be sure the previous person did not leave behind anything of value?
14. Has a standard fee schedule for this service been adopted?
15. Are all collections of rental income recorded when received?
16. Are all safe deposit boxes where lessee is delinquent in rent, flagged or otherwise marked so that access will be withheld until rent is paid?
17. Is there a file maintained of all attachments, notices of bankruptcy, letters of guardianship and letters testamentary served on the bank?
18. Is an acknowledgment of receipt of all property, and a release of liability signed upon termination of occupancy?
19. Are locks changed when boxes are surrendered, whether or not keys are lost?
20. Is drilling of boxes witnessed by two individuals?
21. Are the contents of drilled boxes inventoried, packaged, and placed under dual control?
*22. Are all extra locks and keys maintained under dual control?

Conclusion

23. 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.
24. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

ITEMS IN SAFEKEEPING

*25. Are such items segregated from bank-owned assets and maintained under dual control?
26. Is there a set charge or schedule of charges for this service?

27. Do bank policies prohibit holding items in safekeeping free of charge?
28. Are duplicate receipts issued to customers for items deposited in safekeeping?
29. Are the receipts prenumbered?
*30. Is a safekeeping register maintained to show details of all items for each customer?
*31. Is a record maintained of all entries to custodial boxes or vaults?
32. Does the bank refuse to accept sealed packages when the contents are unknown?
33. If the bank has accepted sealed packages for safekeeping, the contents of which are not described, has the approval of the bank's counsel been obtained?
34. When safekeeping items are released, are receipts obtained from the customer?

Conclusion

35. 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.
36. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CUSTODIAN ACCOUNTS

(Omit this section if the bank's trust department handles such accounts).

*37. Does the bank have written contracts on hand for each account that clearly define the functions to be performed by the bank?
38. Has bank counsel reviewed and approved the type and content of the contracts being used?
39. Does the bank give customers duplicate receipts with detailed descriptions, including dates of coupons attached, if applicable, for all items accepted?
40. Are those receipts prenumbered?
41. Do bank procedures prohibit its holding any investments not covered by a sale or purchase order in this department?
42. Are all orders for the purchase and sale of investments properly authorized in the account contract or signed by customers?
43. For coupon securities held by the bank:
    a. Is a tickler file or other similar system used to ensure prompt coupon redemption on accounts where the bank has been authorized to perform that service?
    b. Are procedures in effect to prevent clipping of coupons where bank is not so authorized?
    c. Have procedures been adopted to insure prompt customer credit when coupon proceeds or other payments are received?
*44. Are all investment items handled in this area maintained under dual control?
45. Have procedures been established for withdrawal and transmittal of items to customers?
*46. Does an officer review and approve all withdrawals prior to the transaction?
47. Has a standard fee schedule for this service been adopted?

Conclusion

48. 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.
49. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

COLLECTION ITEMS

50. Is access to the collection area controlled (if so, indicate how)?
*51. Are permanent registers kept for incoming and outgoing collection items?
52. Are all collections indexed in the collection register?
53. Do such registers furnish a complete history of the origin and final disposition of each collection item?

54. Are receipts issued to customers for all items received for collection?
55. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?
*56. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collection items?
57. Is a record kept to show the various collection items which have been paid and credited as a part of the day's business?
58. Is an itemized daily summary made of all collection fees, showing collection numbers and amounts?
59. Are employees handling collection items periodically rotated, without advance notification, to other banking duties?
*60. Is the employee handling collection items required to make settlement with the customer on the same business day that payment of the item is received?
61. Does the bank have an established policy of not allowing the customer credit until final payment is received?
*62. Have procedures been established, including supervision by an officer, for sending tracers and inquiries on unpaid collection items in the hands of correspondents?
63. In the event of nonpayment of a collection item, is the customer notified and the item promptly returned?
*64. Are the files of notes entered for collection clearly and distinctly segregated from bank-owned loans and discounts?
*65. Are collection notes above maintained under memorandum control and is the control balanced regularly?
66. Are collection files locked when the employee handling such items is absent?
67. Are vault storage facilities provided for collection items carried over to the next day's business?
*68. Does the collection teller turn over all cash to the paying teller at the close of business each day and start each day with a standard change fund?
69. Has a standard fee schedule for this service been adopted?
70. Is the fee schedule always followed?
71. Is a permanent record maintained for registered mailed?

Conclusion

72. 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.
73. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

CONSIGNED ITEMS

*74. Is the reserve stock of consigned items maintained under dual control?
75. Are working supplies kept to a reasonable minimum, i.e., two or three days' supply, and adequately protected during banking hours?
*76. Is a memorandum control maintained of consigned items?
77. Are separate accounts with the consignor maintained at each issuing location (branch), if applicable?
*78. Is the working supply put in the vault at night and over weekends or holidays or is it otherwise protected?
79. Are remittances for sales made on a regularly scheduled basis, if not daily?

Conclusion

80. 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.
81. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Effective date May 1996

Section 4570.1

INTRODUCTION

State member banks have, at times, engaged in issuing nondeposit debt securities on their own behalf or assisted in the sale of these instruments (for example, commercial paper or other short-term or long-term debt securities, such as thrift notes and subordinated debentures) on behalf of their parent bank holding companies or other affiliates. It is important to ensure that these securities are not issued, marketed, or sold in a manner that could give the purchaser the impression that the obligations are federally insured deposits. Consequently, state member banks and their subsidiaries that have issued or plan to issue nondeposit debt securities 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.

PROCEDURES

This policy is not intended to prevent banks from selling their uninsured debt instruments in a manner that is consistent with sound and prudent banking practices. These instruments generally may be sold to investors in various ways away from the retail deposit-taking and general lobby areas of the bank. In this regard, personnel not regularly involved in deposit-taking activities or in opening new deposit accounts may make prospective investors in the community aware of uninsured debt obligations outside of the retail deposit-taking and general lobby areas. Also, these instruments may generally be sold by an employee or officer segregated from the retail deposit-taking and general lobby areas of the bank, even if the employee or officer occasionally accepts deposits or opens an account (but not as a part of his or her regular duties), so long as the arrangement is not structured in a way that misleads the purchaser or is otherwise contrary to supervisory guidelines.

Further, state member banks involved in this activity should establish procedures to ensure that potential purchasers understand that the debt security is not federally insured or guaranteed. Specifically, the debt security should boldly state on its face that it is not insured by the Federal Deposit Insurance Corporation. In addition, this information should be verbally stated to the purchaser, and, in cases where purchasers do not take physical possession of the obligation, the purchaser should be provided with printed advice that conveys this information.

SUPERVISORY GUIDANCE

As noted, a state member bank may also become involved in the sale of uninsured debt obligations of its parent bank holding company or a nonbank affiliate. It is a longstanding policy of the Federal Reserve that debt obligations of a bank holding company or a nonbank affiliate not be issued, marketed, or sold in a way that conveys the misimpression or misunderstanding that these instruments are either (1) federally insured deposits or (2) obligations of or guaranteed by the subsidiary bank. The purchase of these holding company obligations by retail depositors of the subsidiary bank can, in the event of default, result in losses to individuals who believed that they had acquired federally insured or guaranteed instruments. In addition to the problems created for these individuals, this situation could impair public confidence in the bank and lead to unexpected withdrawals or liquidity pressures.

If a state member bank intends to market or sell or to allow its parent holding company or a nonbank affiliate to market or sell uninsured nondeposit debt obligations on bank premises, the bank should establish internal controls to ensure that the promotion, sale, and subsequent customer relationship resulting from the sale of these debt obligations is separated from the retail deposit-taking functions of the bank. For further information on commercial paper, see section 2030, “Bank Dealer Activities.”

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises
Examination Objectives
Effective date May 1996

Section 4570.2

1. To determine if uninsured nondeposit debt obligations of the state member bank or an affiliate are sold on bank premises.
2. To determine if the policies, practices, procedures, and internal controls for the sale of uninsured nondeposit debt instruments are adequate.
3. To ensure that the marketing and sale of uninsured nondeposit debt instruments are not conducted in a manner that conveys the impression or suggestion that they are federally insured deposits. Additionally, holding company or affiliate instruments should not convey the impression or suggestion that they are obligations of or guaranteed by the state member bank.
4. To ensure that the marketing and sale of uninsured nondeposit debt obligations are sufficiently separated and distinguished from retail banking operations, particularly the deposit-taking function.
5. To initiate corrective action if policies, practices, or procedures related to the sale of uninsured nondeposit debt instruments are deficient.

Sale of Uninsured Nondeposit Debt Obligations on Bank Premises

Examination Procedures

Effective date September 1992

Section 4570.3

1. Verify that the bank does not sell uninsured nondeposit debt instruments at teller windows or other areas where retail deposits are routinely accepted, including general lobby areas surrounding teller windows and personal banking desks.
2. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured nondeposit debt obligations from the retail deposit-taking function by assuring that:
   a. the debt instrument, advertising, and all related documents disclose prominently in bold print that the debt instrument is not insured by the Federal Deposit Insurance Corporation (bank holding company debt instruments should also state that the instrument is not an obligation of, or guaranteed by, the bank);
   b. advertisements that promote uninsured debt obligations of the bank (or an affiliate) do not also promote insured deposits of the bank in a way that could lead to confusion;
   c. the obligor of the uninsured debt instrument is prominently disclosed and names or logos of the bank are not used on holding company or nonbank affiliate instruments in a way that might suggest the insured bank is the obligor;
   d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale (a review of employee instructions or a telemarketing script, or appropriate questions directed to an employee handling this function, could assist an examiner in assessing the adequacy of verbal disclosure);
   e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured nondeposit debt instruments;
   f. information on uninsured nondeposit debt instruments is not contained in the retail deposit statements of customers or in the immediate retail deposit-taking area; and
   g. account information on holdings of uninsured nondeposit debt instruments is not included on insured deposit statements.
3. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the uninsured debt instrument is not a deposit and is not FDIC insured.

Depository institutions have become increasingly involved in selling uninsured nondeposit investment products, such as mutual funds or annuities, on their premises to retail customers. In response to this development, an interagency statement on retail sales of nondeposit investment products (interagency statement) was issued on February 15, 1994, to enhance customer protection and lessen possible customer confusion that these products are insured deposits.[1] The interagency statement applies to all insured banks and thrifts, including state member banks and the U.S. branches and agencies of foreign banks.

The guidelines contained in the interagency statement apply to retail recommendations or sales of nondeposit investment products made by—

- employees of a depository institution,
- employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises), and
- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

Retail sales include (but are not limited to) sales to individuals by depository-institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. The sales of government and municipal securities made in a depository institution's dealer department located away from the lobby area are not subject to the interagency statement. In addition, the interagency statement generally does not apply to fiduciary accounts administered by a depository institution. However, for fiduciary accounts where the customer directs investments, such as self-directed individual retirement accounts, the disclosures prescribed by the interagency statement (see the "Disclosures and Advertising" subsection below) should be provided. Furthermore, the interagency statement applies to affiliated broker-dealers when the sales occur on the premises of the depository institution. The interagency statement also applies to sales activities of an affiliated broker-dealer resulting from a referral of retail customers by the depository institution.

The Rules of Fair Practice of the Financial Industry Regulatory Authority govern sales of securities by its member broker-dealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities and require that sales of registered securities be accompanied by a prospectus that complies with SEC disclosure requirements.

Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on bank premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit-taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the interagency statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should also apply the examination procedures prescribed in SR-94-34 ("Examination Procedures for Retail Sales of Nondeposit Investment Products," May 26, 1994) when retail customers are directed to the institution's trust department, where they may purchase nondeposit investment products by simply completing a customer agreement.

PROGRAM MANAGEMENT

Banks must adopt policies and procedures governing nondeposit investment product retail sales programs. These policies and procedures should be in place before the commencement of the retail sale of nondeposit investment products on bank premises.

The bank's board of directors is responsible for ensuring that retail sales of nondeposit investment products comply with the interagency statement and with all applicable state and federal laws and regulations. Therefore, the

1. The interagency statement was issued to Federal Reserve Banks under cover of a supervisory letter, SR-94-11 ("Interagency Statement on Retail Sales of Nondeposit Investment Products," February 17, 1994). Additional guidance is provided in SR-95-46 ("Interpretation of Interagency Statement on Retail Sales of Nondeposit Investment Products," September 14, 1995).

board, or a designated committee of the board, should adopt written policies that address the risks and management of these sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, the institution's arrangements with any third parties selling these products on bank premises. The bank's policies and procedures should be reviewed periodically by the board of directors, or its designated committee, to ensure that they are consistent with the institution's current practices, applicable laws, regulations, and guidelines.

A bank's policies and procedures for nondeposit investment products should, at a minimum, address (1) disclosure and advertising, (2) the physical separation of investment sales from deposit-taking activities, (3) compliance and audit requirements, (4) suitability concerns, and (5) other sales practices and related risks. In addition, policies and procedures should address the following areas.

Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of the bank's customers. Policies should outline the criteria and procedures that will be used to select and periodically review nondeposit investment products that are recommended or sold on the bank's premises. Institutions should periodically review the products offered to ensure that they meet their customers' needs.

Use of Identical or Similar Names

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the bank or its affiliates. However, a bank may sell a nondeposit investment product with a similar name as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule to investment adviser activities under Regulation Y (12 CFR 225.125) when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment advisor to a mutual fund. In this case, the fund may not have a name that is identical to, similar to, or a variation of the name of the bank holding company.

Permissible Use of Customer Information

Banks should adopt policies and procedures on the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The industry guidelines permit institutions to share with third parties only limited customer information, such as the name, address, telephone number, and types of products owned. The guidelines do not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments or net worth, without the customer's prior acknowledgment and written consent.

Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under these arrangements, the third party has access to the institution's customers, and the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to sell the products directly. Third parties include wholly owned subsidiaries of a bank, bank-affiliated broker-dealers (section 20 companies[2] or discount brokerage firms), unaffiliated broker-dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

Bank management should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. The review should include an assessment of the third party's

2. A nonbank subsidiary of a bank holding company that has been authorized to underwrite and deal in certain debt and equity securities that cannot be underwritten or dealt in by member banks directly.

financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including its compliance with the interagency statement.

Banks should enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on bank premises. These agreements should be approved by the bank's board of directors or its designated committee. Agreements should outline the duties and responsibilities of each party; describe third-party activities permitted on the institution's premises; address the sharing or use of confidential customer information for investment sales activities; and define the terms for use of the bank's office space, equipment, and personnel. If an arrangement includes dual employees (bank employees also utilized by a third party), the agreement must provide for written employment contracts that specify the duties of these employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the interagency statement. The agreement should authorize the institution to monitor the third party's compliance with its agreement, as well as authorize the bank and Federal Reserve examination staff to have access to third-party records considered necessary to evaluate this compliance. These records should include examination results, sales practice reviews, and related correspondence provided to the third party by securities regulatory authorities. Finally, the agreement should provide for indemnification of the institution by an unaffiliated third party for the conduct of its employees in connection with its sales activities. Notwithstanding the provisions of a third-party agreement, bank management should monitor the conduct of nondeposit investment product sales programs to ensure that sales of the products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for these investments.

Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates and stock market valuations. In the event of a sudden, sharp drop in the market value of nondeposit investment products, institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Therefore, management should develop contingency plans to address these situations. A major element of any contingency plan should be to provide customers with access to information about their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

DISCLOSURES AND ADVERTISING

Content, Form, and Timing of Disclosures

Nondeposit investment product sales programs should ensure that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The interagency statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the FDIC.
- They are not deposits or other obligations of the institution and are not guaranteed by the institution.
- They are subject to investment risks, including the possible loss of the principal invested.

There are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in lieu of the longer written disclosures.

The interagency statement disclosures do not need to be provided in the following situations:

- radio broadcasts of 30 seconds or less;
- electronic signs,[3] and
- signs, such as banners and posters, when they are used only as location indicators.

3. "Electronic signs" may include billboard-type signs that are electronic, time-and-temperature signs, and ticker-tape signs. Electronic signs would not include such media as television, on-line services, or ATMs.

Additionally, third-party vendors not affiliated with the depository institution need not make the interagency statement disclosures on nondeposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution.

Shorter, logo-format disclosures may be used in visual media, such as television broadcasts, ATM screens, billboards, signs, posters, and written advertisements and promotional materials, such as brochures. The text of an acceptable logo-format disclosure would include the following statements:

- Not FDIC-Insured.
- No Bank Guarantee.
- May Lose Value.

Disclosure is the most important way of ensuring that the differences between nondeposit investment products and insured deposits are understood by retail customers. Accordingly, it is critical that the minimum disclosures be presented clearly and concisely in both oral and written communications. In this regard, the minimum disclosures should be provided—

- orally during any sales presentations (including telemarketing contacts) or when investment advice is given,
- orally and in writing before or at the time an investment account to purchase these products is opened, and
- in all advertisements and other promotional materials (discussed further below).

The minimum disclosures may be made on a customer account agreement or on a separate disclosure form. The disclosures must be conspicuous (highlighted through bolding, boxes, and/or a larger typeface). Disclosures contained directly on a customer account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banks are to obtain a written acknowledgment—on the customer account agreement or on a separate form—from a customer confirming that he or she has received and understands the minimum disclosures. For nondeposit investment product accounts established before the issuance of the interagency statement, banks should obtain a disclosure acknowledgment from the customer at the time of the customer's next purchase transaction. If an institution solicits customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgment to be signed and returned to the institution.

Customer account statements, including combined statements for linked accounts and trade confirmations that are provided by the bank or an affiliate, should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements that provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. When promotional sales materials related to nondeposit investment products are displayed in the bank's retail areas, they should be grouped separately from material related to insured bank products.

Telemarketing scripts should be reviewed to determine whether bank personnel are inquiring about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In these cases, the scripts must contain the minimum disclosures, and bank personnel relying on the scripts must be formally authorized to sell nondeposit investment products by their employers. Further, these personnel must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see the "Training" subsection below).

Additional Disclosures

A bank should apprise customers of certain material relationships. For example, a customer should be informed by sales personnel orally and in writing before the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the institution. Similarly, fees, penalties, or surrender charges associated with a nondeposit investment product should be disclosed by sales personnel orally and in writing before or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than the FDIC (for example, SIPC insurance of broker-dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage must also be provided to customers at that time to minimize possible confusion with FDIC insurance. These disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

SETTING AND CIRCUMSTANCES

Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on bank premises may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, recommend investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

To decide whether nondeposit investment product sales activities are sufficiently separate from deposit activities, the particular circumstances of each bank need to be evaluated. FDIC insurance signs and insured deposit-related promotional material should be removed from the investment product sales area and replaced with appropriate signs indicating that the area is used for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

In the case of banks that are affiliated with section 20 companies that sell retail investment products directly to bank customers, the requirement for separation of deposit-taking facilities from the securities operations of the section 20 company is absolute under the relevant firewall conditions imposed on these companies by the Board. Accordingly, retail sales activities conducted by a section 20 company must be in a separate office which, at a minimum, is set off from deposit-taking activities by partitions and identified by signs with the name of the section 20 company. Further, section 20 company employees may not be dual employees of the bank. Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker-dealer.

The interagency statement was intended generally to cover sales made to retail customers in the bank lobby. However, some institutions may have an arrangement whereby retail customers purchase nondeposit investment products at a location of the institution that is generally confined to institutional services (for example, corporate money desk). In these cases, the bank should still ensure that retail customers receive the minimum disclosures to minimize any possible customer confusion with nondeposit investment products and insured deposits.

Hybrid Instruments and Accounts

When an institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash-management account,[4] the accounts should be opened in the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, and the institution should take special care during the account-opening process to ensure that a customer is accurately informed that

4. A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements.

- funds deposited into a sweep account will only be FDIC-insured until they are swept into a nondeposit investment product account and
- customer account statements may disclose balances for both insured and nondeposit product accounts.

DESIGNATION, TRAINING, AND SUPERVISION OF PERSONNEL

Hiring and Training of Sales Personnel

Banks hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. When a candidate for employment has previous investment industry experience, the bank should check whether the individual has been the subject of any disciplinary actions by securities, state, or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer-protection issues. In addition, training programs should cover the bank's policies and procedures for sales of nondeposit investment products and should be conducted continually to ensure that staff are familiar with new products and compliance issues.

For those bank employees whose sales activities are limited to mutual funds or variable annuities, the equivalent training is that ordinarily needed to pass NASD's series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third-party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, bank management should be satisfied that the third party is able to train third-party and dual employees with respect to compliance with the minimum disclosures and other requirements of the interagency statement. Copies of third-party training and compliance materials should be obtained and reviewed by the bank to monitor the third party's performance regarding its training obligations.

Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products, but who may refer customers to authorized nondeposit investment products sales personnel, should receive training about the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, prequalify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. These personnel may contact customers for the purposes of—

- determining whether the customer wishes to receive investment information
- inquiring whether the customer wishes to discuss investments with an authorized sales representative, and
- arranging appointments to meet with authorized bank sales personnel or third-party broker-dealer registered sales personnel.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not provide investment advice, identify specific investment products, or make investment recommendations.

Supervision of Personnel

Bank policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as the referral activities of bank employees not authorized to sell these products. Personnel responsible for managing the sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal, as required by the NASD for broker-dealers. Supervisory personnel should be responsible for the bank's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the interagency statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the interagency statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

SUITABILITY AND SALES PRACTICES

Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on the bank's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the bank is responsible for the preservation of the principal of their investment.

Banks that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing the suitability of investment recommendations and related recordkeeping requirements. Sales personnel that recommend nondeposit investment products to customers should have reasonable grounds for believing that the recommended products are suitable for the particular customer on the basis of information he or she has provided. A reasonable effort must be made to obtain, record, and update information concerning the customer's financial profile (for example, tax status, other investments, income), investment objectives, and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the bank's policies and procedures. The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded, and updated (for subsequent purchases) and should determine whether investment recommendations appear unsuitable in light of this information.

Nondeposit investment product sales programs conducted by third-party broker-dealers are subject to the NASD's suitability and other sales practice rules. To avoid duplicating NASD examination efforts, examiners should rely on the NASD's most recent sales practice review of the third party, when available. If an NASD review has not been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

Sales Practices and Customer Complaints

Banks should have policies and procedures that address undesirable practices by sales personnel, such as practices to generate additional commission income for the employee by churning or switching accounts from one product to another. Banks should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable timeframes should be established for addressing complaints.

COMPENSATION

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring prospective customers to an authorized sales representative, and nonmonetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (for example, mutual fund distributors) to bank staff must be approved in writing by bank management, be consistent with the bank's written internal code of conduct for the acceptance of remuneration from third parties, and be consistent with the proscriptions of the Bank Bribery Act (18 USC 215) and the banking agencies' implementing guidelines to that act. Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way that they result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (such as a proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the group's overall performance in meeting bank objectives for a broad variety of bank services and products and not on the volume of sales of nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed-dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of the fee should not depend on whether the referral results in a transaction. Nonmonetary compensation to bank employees for referrals should be similarly structured. Auditors and compliance personnel should not participate in incentive compensation programs that are directly related to the results of nondeposit investment product sales programs.

COMPLIANCE

Banks must develop and maintain written policies and procedures that effectively monitor and assess compliance with the interagency statement and other applicable laws and regulations and that ensure appropriate follow-up to correct identified deficiencies. Compliance programs should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance findings should periodically be reported to the bank's board of directors or a designated committee of the board as part of the institution's ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training and experience with nondeposit investment product sales programs, applicable laws and regulations, and the interagency statement.

Banks should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potentially abusive practices, such as unsuitable recommendations, churning, or switching. Compliance personnel should also oversee the prompt resolution of customer complaints and review complaint logs for questionable sales practices. Management-information-system reports on early redemptions and sales patterns for specific sales representatives and products should also be used by compliance personnel to identify any potentially abusive practices. In addition, the referral activities of bank personnel should be reviewed to ensure that they conform to the guidelines in the interagency statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including its conformance to the disclosure and separate-facilities guidelines of the interagency statement. The results of this oversight should be reported to the board of directors or a designated committee of the board. Management should obtain the third party's commitment to promptly correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

AUDITS

Audit personnel should be responsible for assessing the effectiveness of the institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit reviews of nondeposit investment product activities will depend on the complexity and sales volume of a sales program and on whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the interagency statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Findings should be reported to the board of directors or to a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

Retail Sales of Nondeposit Investment Products
Examination Objectives
Effective date May 1996

Section 4580.2

1. To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and nondeposit investment products and that they receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.
2. To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.
3. To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the interagency statement, Federal Reserve guidelines, regulations, and applicable laws.
4. To assess the effectiveness of the institution's compliance and audit programs for nondeposit investment product operations.
5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or when the institution has failed to comply with the interagency statement or applicable laws and regulations.

Retail Sales of Nondeposit Investment Products
Examination Procedures

Effective date September 1992

Section 4580.3

1. Verify through the minutes of the board of directors that the directors have approved the sale of uninsured annuities, reviewed, and approved the choice of an underwriter in the past year.
2. Determine if the bank adequately evaluates the underwriter's financial condition at least annually and regularly reviews the credit ratings assigned to the underwriter by at least two independent agencies evaluating annuity underwriters. (Banks engaged in the sale of annuities are expected to sell only products of financially secure underwriters and to make current ratings of the underwriter available to an investor when purchasing an uninsured annuity.)
3. Verify that the bank does not sell uninsured annuities at teller windows or other areas where retail deposits are routinely accepted.
4. Assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by ensuring that—
   a. the contract, advertising, and all related documents disclose prominently in bold print that the annuities are not deposits or obligations of an insured depository institution and are not insured by the Federal Deposit Insurance Corporation;
   b. advertisements do not contain words, such as "deposit," "CD," etc., that could lead an investor to believe an annuity is an insured deposit instrument;
   c. the obligor of the annuity contract is prominently disclosed and names or logos of the insured bank are not used in a way that might suggest the insured bank is the obligor;
   d. adequate verbal disclosures are made during telemarketing contacts and at the time of sale;
   e. retail deposit-taking employees of the insured depository institution are not engaged in the promotion or sale of uninsured annuities;
   f. information on uninsured annuities is not contained in retail deposit statements of customers (either as advertising on deposit statements or as "junk mail" stuffers included with deposit statements) or in the immediate retail deposit-taking area;
   g. account information on annuities owned by customers is not included on insured deposit statements; and
   h. officer or employee remuneration associated with selling annuities is limited to reasonable levels in relation to the individual's salary. (As a guideline in reviewing remuneration, see the Board's policy statement on disposition of credit life insurance, as discussed in the Consumer Credit, Examination Procedures, section of this manual.)
5. If the bank allows a third-party entity to market annuities on depository-institution premises, assess the adequacy of disclosures and the separation of the marketing and sale of uninsured annuities from the retail deposit-taking function by determining that—
   a. the bank has ensured that the third-party company is properly registered or licensed to conduct this activity,
   b. bank personnel are not involved in sales activities conducted by the third party,
   c. desks or offices used to market or sell annuities are separate and distinctly identified as being used by an outside party, and
   d. bank personnel do not normally use desks or offices used by a third party for annuities sales.
6. Encourage the bank to obtain a signed statement from the customer indicating that the customer understands that the annuity is not a deposit or any other obligation of the bank, that the bank is only acting as an agent for the insurance company (underwriter), and that the annuity is not FDIC-insured.

5000—OTHER EXAMINATION AREAS

The 5000 series of sections provide background on the supervisory assessment of certain bank activities in which a state member bank may or may not engage. These examination activities are sometimes referred to as “specialty examinations” and are conducted by examiners who have subject matter expertise or specialized training. More specifically, there is a section on a bank’s fiduciary or asset and wealth management activities. There are also sections that are salient to the supervisory assessment of information technology and payment systems risks.

Fiduciary activities and other related services generally include traditional trust services, such as personal trust, corporate trust, and transfer-agent services and employee benefit account products and services, as well as custody and securities-lending services, clearing and settlement, private banking, asset management, and investment advisory activities. (See SR-01-5.)

Pursuant to 12 USC 24 (seventh), 92a, and 93a, the Office of the Comptroller of the Currency (OCC) has established standards (the OCC rules for fiduciary activities of national banks). These rules are typically considered the industry standard for fiduciary activities of all financial institutions operating in the United States. (See 12 CFR 9.) When considering whether a state member bank has adhered to industry standards for fiduciary activities, Federal Reserve System (FRS) examiners can refer to the guidance set forth in the OCC rules and FRS and OCC examination manuals, as well as the examination materials issued by other U.S. financial institution regulatory agencies. With respect to a state member bank subsidiary, the appropriate bank, thrift, or functional regulator has the primary supervisory responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity that the regulator supervises. (See SR-00-13.) Examiners should seek to use the examination findings of the functional regulator.

A risk-focused fiduciary examination concentrates on understanding and evaluating risk and assessing the internal controls the state member bank has employed to manage risk. The program encompasses continuous monitoring; targeted reviews of fiduciary activities; preparation of supervisory risk profiles and assessments; and the development of supervisory plans, which are integrated into the preplanning of an examination. Conclusions are used to develop an overall safety-and-soundness evaluation of the state member bank's fiduciary activities. (See SR-96-10.)

The Federal Reserve System's fiduciary-examination program reviews and assesses the risk-management practices and related aspects of a state member bank's fiduciary activities. This approach results in (1) the use of a more diversified examiner population, including those with capital-markets, information systems, and safety-and-soundness experience; (2) an emphasis on assessing the individual organization's unique risk profile; and (3) reviews of risk identification, measurement, monitoring, and control. Examiners should use the state member bank's control disciplines (internal audit, risk management, and compliance program) whenever possible.

Examiners have access to a broad variety of FRS supervisory information and analytical support tools to evaluate the fiduciary activities of financial institutions. The Uniform Bank Performance Report (UBPR) can assist examiners in evaluating a state member bank's fiduciary business lines or activities relative to its peers. (See the UBPR, pages Trust 1 and Trust 1A.) Beginning with the December 2002 release, "Section II: Technical Information" of the *UBPR User's Guide* (available online at www.ffiec.gov/ubprguide.htm) discusses the availability of the Total Fiduciary Assets within a fiduciary group number (peer group). (See page II-3.) "Total Fiduciary Assets" are the totals of managed and nonmanaged fiduciary assets for FDIC-insured commercial and savings banks, as reported on Schedule RC-T of the call report.

COMPLEX FIDUCIARY ORGANIZATIONS

SR-01-5 explains that complex fiduciary organizations are those banking organizations that conduct significant or complex fiduciary activities. This includes large complex banking organizations (LCBOs), other large or regional institutions for which fiduciary activities represent a significant portion of their business, and clearing agencies registered with the Securities and Exchange Commission (SEC) for which the Federal Reserve is the primary supervisor. The fiduciary-examination frequency should be determined on the basis of the impact that fiduciary activities have on the organization's risk profile. At a minimum, all material fiduciary business lines should be subject to examination over a two-year period or examination cycle as part of the continuous supervision process, with higher-risk areas generally reviewed annually.

Composite Uniform Interagency Trust Rating System (UITRS) ratings and transfer-agent ratings reflecting the overall condition of the fiduciary function at each institution, and any component ratings considered relevant, should be assigned or updated in a timely manner on the basis of the results of examinations, targeted reviews, or other assessments of fiduciary activities. UITRS ratings do not need to be assigned for each targeted business-line review. However, at a minimum, composite UITRS and transfer-agent ratings should be updated annually, and any material findings related to these areas should be included in the annual summary supervisory report. Any significant concerns should be reflected in the safety-and-soundness examination ratings. Fiduciary risks and fiduciary-risk management assessments should also be reflected in the relevant risk-assessment and risk-management ratings for the banking organization, as necessary.

OTHER INSTITUTIONS OFFERING FIDUCIARY AND TRANSFER-AGENT SERVICES

The frequency of fiduciary and transfer-agent examinations for other institutions, generally smaller state-chartered Federal Reserve member banks and trust companies with noncomplex operations, should be determined on the basis of the significance of their fiduciary and transfer-agent activities and an assessment of the level of risk the activities present to the institution. This scheduling guidance also applies to initial examinations of new institutions and to those institutions subject to Federal Reserve supervision as a result of a charter conversion.

At a minimum, fiduciary activities should be reviewed no less frequently than during every other routine safety-and-soundness examination. Examinations governed by alternating examination programs with state banking authorities may continue to be performed in accordance with those arrangements or as necessary to incorporate the provisions of SR-01-5. Examinations of fiduciary activities at noncomplex limited-purpose trust companies and other fiduciary institutions subject to supervision by the Federal Reserve that do not receive routine safety-and-soundness examinations should be conducted no less frequently than every two years.

Composite UITRS and transfer-agent examination ratings reflecting the overall condition of the function, and any component ratings considered relevant, should be assigned or updated at the completion of the examination or assessment. Material examination findings should be integrated into the overall examination report for the institution, which should clearly indicate the significance of any findings to the safety and soundness of the institution and the impact of the findings on any relevant risk assessments and risk-management ratings.

ORGANIZATIONS WITH SUPERVISORY CONCERNS

Organizations whose fiduciary activities have raised supervisory concerns should be subject to an additional level of supervisory attention on the basis of the severity of those supervisory concerns. Generally, this would include those organizations with a composite UITRS rating of 3, 4, or 5; a transfer-agent rating of B or C; or significant deficiencies in one or more component-rating categories. In the case of an institution assigned a UITRS rating of 4 or 5 or a transfer-agent rating of C, supervisory action should be initiated promptly and continued until the problems or deficiencies have been appropriately addressed.

Under the Securities and Exchange Act of 1934, the Federal Reserve continues to be responsible for examining transfer agents and clearing agencies for which it is the primary supervisor, including reviewing compliance with SEC rules. Any material violations of transfer-agent or clearing-agency rules must be reported promptly to Board staff to facilitate coordination with the SEC.

RISK PROFILE OF FIDUCIARY ACTIVITIES

Regular supervisory assessments of the risk of fiduciary activities, as outlined in SR-01-5, support the supervisory process. Risk profiles for LCBOs are updated quarterly. These risk profiles should include explicit consideration of the risks of fiduciary activities. For other complex fiduciary organizations, risk profiles reflecting fiduciary activities should be prepared and updated as needed, but no less frequently than annually. For these organizations, supervisory plans should detail the fiduciary specialist's recommended examination coverage of fiduciary activities. For banking organizations supervised by the Federal Reserve that have smaller, noncomplex fiduciary operations, formal risk profiles may not be necessary. However, fiduciary-risk information should normally be updated at each examination or inspection and incorporated into supervisory plans.

Risk profiles should include an assessment of the inherent risk in the organization's fiduciary activities, as well as a consideration of the effectiveness of its risk management. Risk assessments would normally include the following factors:

- the size and number of fiduciary accounts and assets administered
- the nature and complexity of fiduciary products and services offered
- significant changes to management or staffing for fiduciary services
- significant changes to data processing systems supporting fiduciary services
- new affiliations, partnerships, or outsourcing arrangements
- changes in strategic direction affecting fiduciary services or exposure to emerging risks
- significant litigation, settlements, or charge-offs
- the length of time since the last on-site examination in which fiduciary activities were reviewed, and the scope of that examination
- the significance of prior examination findings
- the effectiveness of the organization's control environment, including its audit function, and the adequacy of its risk-management practices relative to the nature and scope of its business

RISK FOCUS

As explained in SR-96-10, for a complex institution, fiduciary examiners will direct their attention to assessing the organization's functions and its ability to identify, measure, monitor, and control fiduciary, market, credit, and operational risks. Examiners should assess risks that result from the fiduciary's investment-management, investment advisory, mutual funds, global custody, and securities-lending and processing activities. Any other activities that are subject to adverse movements in market rates or prices, or to operating problems associated with processing a large volume of securities, should also be assessed. These fiduciary activities could result in material losses to trust customers and, in turn, expose the institution to financial losses and litigation if not conducted in a manner consistent with the fiduciary's duty of loyalty and the investor's stated objectives.

A review of internal controls and policies and procedures is an integral part of the examination program. Facets of a fiduciary examination include management competence and accountability, management's review of risks associated with the introduction of new products and services, and management's overall risk awareness.

The emphasis on risk assessment and control parallels the guidelines and procedures pertaining to state member bank examinations and bank holding company inspections, as described in SR-95-51 and SR-16-11, and recognizes the efforts of many progressive institutions in establishing fiduciary-risk assessment and control initiatives of their own. When rating the quality of risk management of fiduciary activities, examiners should place primary consideration on findings relating to the following elements of a sound risk-management system: (1) active board and senior management oversight; (2) adequate policies, procedures, and limits; (3) adequate risk-measurement, -monitoring, and management information systems; and (4) comprehensive internal controls. Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of each element.

Active Board and Management Oversight

Given that a board of directors has ultimate responsibility for all of the activities of its institution, the board should approve overall fiduciary business strategies and policies, including those related to identifying, measuring, monitoring, and controlling fiduciary risks. A board of directors must understand the nature of the risks that are significant to the organization, and it should ensure that management is taking the steps necessary to manage these risks.

Senior management has the responsibility for implementing approved strategies in a way that will limit fiduciary risks and ensure compliance with laws and regulations. Senior management should, therefore, be fully involved in the fiduciary activities of their institution and have sufficient knowledge of all fiduciary business lines to ensure that necessary policies, controls, and risk-monitoring systems are in place and that accountability and lines of authority are clearly defined. In assessing the quality of fiduciary oversight by boards of directors and senior management, examiners should consider whether these conditions exist:

- The board and senior management have a clear understanding and working knowledge of the types of fiduciary activities the institution performs and of the risks inherent in them. They have approved appropriate policies, procedures, recordkeeping systems, and reporting systems to support the fiduciary activities and to help measure and monitor risks. They have established procedures to stay informed about changes in fiduciary activities and the associated risks.
- Management at all levels adequately supervises the daily activities of officers and employees to ensure that the lines of fiduciary business are managed and staffed by persons whose knowledge, experience, and expertise are consistent with the nature and scope of the organization's fiduciary activities.
- Before offering new services or introducing new products, management identifies the fiduciary risks associated with them and ensures that internal controls are in place to manage the service or product and its accompanying risk.

Adequate Policies, Procedures, and Limits

An institution's directors and senior management should establish fiduciary and fiduciary-risk management policies and procedures commensurate with the types of activities the institution conducts. The policies and procedures should provide enough detailed guidance to ensure that all material areas of fiduciary activity and risk are addressed. They should also be modified when necessary to respond to changes in the organization's activities. A smaller, less complex institution that has effective management and that is heavily involved in daily operations generally would be expected to have more basic policies addressing the significant areas of its activities and setting forth a limited but appropriate set of requirements and procedures. In a larger institution, where senior management must rely on a widely dispersed staff to implement strategies in a wide range of complex situations, far more detailed policies and related procedures would be expected. In assessing the adequacy of an institution's fiduciary and fiduciary-risk management policies and procedures, examiners should consider whether these conditions exist:

- The institution's policies and procedures adequately address the fiduciary activities performed and are consistent with management's experience level and with the institution's stated goals and objectives.
- The institution's policies and procedures provide for adequate identification, measurement, monitoring, and control of the risks posed by its fiduciary activities.
- Policies clearly establish accountability and set forth lines of authority.
- Policies provide for review of new fiduciary services and activities to ensure that they are suitable and consistent with fiduciary-customer objectives, and to ensure that the systems necessary to identify, measure, monitor, and control risks associated with new services and activities are in place before the activity is initiated.

Adequate Risk-Monitoring and Management Information Systems

Risk monitoring requires institutions to identify and measure all areas of material fiduciary risk continuously. Risk-monitoring activities must be supported by management information systems that provide senior management with timely reports on financial condition, operating performance, marketing efforts, new products and services, pending or threatened litigation, and risk exposure arising from fiduciary activities. The information system also must provide regular and more detailed reports for managers engaged in the daily management of the institution's activities.

The sophistication of risk-monitoring and control information systems should be commensurate with the complexity of the institution's fiduciary operations. Less complex institutions may require only a limited number of management reports to support risk-monitoring activities. Larger, more complex institutions, however, would be expected to have much more comprehensive reporting and monitoring systems. These systems would allow for more frequent reporting and closer monitoring of complex activities. In assessing the adequacy of an institution's measurement and monitoring of fiduciary risk, examiners should consider whether these conditions exist:

- The institution's fiduciary-risk monitoring practices and reports encompass all of its business lines and activities, and they are structured to monitor exposures consistent with established goals, limits, and objectives.
- Key assumptions, data sources, and procedures used in identifying, measuring, and monitoring fiduciary risk are appropriate for the activities the institution performs and are adequately documented and continuously tested for reliability.
- Reports to management are accurate and timely and contain sufficient information for policy and decision makers to identify any adverse trends and any potential or real problems. The reports must be adequate for management to evaluate the level of fiduciary risk faced by the institution.

Adequate Internal Controls

A comprehensive internal-control structure is critical to the safe and sound functioning of an institution and its fiduciary-risk management system. Establishing and maintaining a system of internal controls that sets forth official lines of authority and an appropriate segregation of duties is one of management's most important responsibilities.

A well-structured system of internal controls promotes effective fiduciary operations and reliable reporting; safeguards assets; and helps to ensure compliance with laws, regulations, and institutional policies. Controls should be periodically tested by an independent party (preferably the auditor or at least an individual not involved in the process being reviewed) who reports directly to either the institution's board of directors or one of its designated committees. Given the importance of appropriate internal controls to organizations of all sizes and risk profiles, the results of these reviews should be adequately documented, as should management's responses to them. In evaluating the adequacy of an institution's internal controls as they relate to fiduciary activities, examiners should consider whether these conditions exist:

- The system of internal controls is appropriate to the type and level of fiduciary activities.
- The institution's organizational structure establishes clear lines of authority and responsibility.
- Reporting lines are sufficiently independent of the control areas and from the business lines, and there is adequate separation of duties throughout the institution.
- Financial, operational, and regulatory reports are reliable, accurate, and timely.
- Adequate procedures exist for ensuring compliance with laws and regulations.
- Internal-audit or other control-review practices provide for independence and objectivity.
- Internal controls and information systems are adequately tested and reviewed, with findings documented and weaknesses given appropriate and timely attention.
- The board of directors or the audit committee reviews the effectiveness of internal audits and other control-review activities regularly.

The fiduciary-risk assessment and control categories and tools listed above are not all-inclusive. They are guidelines for the fiduciary examiner and fiduciary-activities management to use in their risk-assessment and -control efforts. The examination of fiduciary activities may require some modification, depending on how the activities are organized and the complexity of the products and services offered.

INVESTMENT OF FIDUCIARY ASSETS IN MUTUAL FUNDS AND POTENTIAL CONFLICTS OF INTEREST

Banks and trust institutions encounter various direct or indirect financial incentives to place trust assets with particular mutual funds. These incentives include fees for using nonaffiliated fund families as well as incentives for using an institution's proprietary mutual funds. The primary supervisory concern is that an institution may fail to act in the best interest of its beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may be exposed to an increased risk of legal action by account beneficiaries, and it could potentially violate laws or regulations. The Federal Reserve Board issued SR-99-7 to help institutions minimize these risks and ensure that their activities meet fiduciary standards.

Institutions should ensure that they perform and document an appropriate level of due diligence before entering into any compensation arrangements with mutual fund providers or before placing fiduciary assets in their own proprietary mutual funds. SR-99-7 discusses the type of measures that should be included in this process, including a reasoned legal opinion addressing the activity, appropriate policies and procedures, and documented analysis and ongoing review of investment decisions. For issues pertaining to retail sales of nondeposit investment products and matters relating to compensation, see section 4170.1.

Types of Financial Incentives

Financial incentives for placing trust assets with particular mutual funds range from payments structured as reimbursements for services or for transferring business to an unaffiliated fund family, to financial benefits that arise from using mutual funds that are managed by the institution or an affiliate. In some cases, such as service fees for administrative and recordkeeping functions performed by the trust institution, the permissibility of such payments may be specifically addressed under state law. However, guidance under applicable law may be less clear for other financial incentives. In all cases, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interest of the trust beneficiary.

Certain mutual fund providers offer compensation in the form of ‘‘service’’ fees to institutions that invest fiduciary assets in particular mutual funds. These fees, referred to variously as shareholder, subaccounting, or administrative-service fees, are structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts, such as maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis-point amount of the dollar value of assets invested or on transaction volume.

Nearly every state legislature modified its laws in the 1990s to allow explicitly the acceptance of such service fees by fiduciaries under certain conditions. These conditions often include compliance with standards of prudence, quality, and appropriateness for the account, and a determination of the ‘‘reasonableness’’ of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) also adopted these general standards for national banks.[1] However, the Employee Retirement Income Security Act of 1974 (ERISA) generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.[2] ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

Although there has been no comprehensive review of the extent to which mutual fund providers are offering the types of incentive payments cited above, the practice is not uncommon. In addition to these service fees, another form of compensation reportedly offered by some mutual fund providers is a lump-sum payment based on assets transferred into a mutual fund.

Similar conflict-of-interest concerns are raised by the investment of fiduciary-account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as ‘‘proprietary’’ funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments.[3]

Due-Diligence Measures

Although many state laws explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds,

1. In general, national banks may make these investments and receive such fees if the practice is authorized by applicable law and if the investment is prudent and appropriate for fiduciary accounts and consistent with fiduciary requirements established by state law. These requirements include a ‘‘reasonableness’’ test for any fees received by the institution. (OCC Interpretive Letter No. 704, February 1996.)

2. ERISA section 406(b)(3), Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Board interpretation of Federal Reserve Regulation Y addresses the investment of fiduciary-account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. See *Federal Reserve Regulatory Service* 4–177.

institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Section 23B of the Federal Reserve Act (FRA) requires, before a member bank purchases shares issued by an affiliate, including investment-fund shares, that the board of directors approve the purchase based on a determination that the purchase is a sound investment for the bank, irrespective that an affiliate is the principal underwriter.[4] Even for investments in which the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described above or before placing fiduciary assets in proprietary mutual funds. According to SR-99-7, the following measures should be included in this process:

- *A reasoned legal opinion.* The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of compensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, the trust instrument, or court order, as well as any applicable disclosure requirements or "reasonableness" standard for fees set forth in the law.
- *Establishment of policies and procedures.* The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers, as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations, and sound fiduciary principles, including any disclosure requirements or reasonableness standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.
- *Analysis and documentation of investment decisions.* Where an institution receives fees or other compensation in connection with fiduciary-account investments over which it has investment discretion or where such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons to similar mutual funds, management fees and expense ratios, and ratings by recognized mutual-fund rating services. The institution should also document its assessment that the investment is, and continues to be, appropriate for the individual account, in the best interest of account beneficiaries, and in compliance with section 23B of the FRA and with provisions of the "prudent-investor" or "prudent-man rules," as appropriate.

4. 12 USC 371c-1(b)(2).

UNIFORM INTERAGENCY TRUST RATING SYSTEM

In December 1998, the Federal Reserve Board issued implementing guidelines for the Uniform Interagency Trust Rating System (UITRS).[5] The revised UITRS was made effective for examinations commencing on or after January 1, 1999.[6] Federal Reserve examiners should assign UITRS ratings in conformance with the definitions adopted by the Federal Financial Institutions Examination Council (FFIEC), as augmented by the guidance below.

A full composite UITRS rating is *required* to be assigned as a result of all trust examinations, except for targeted examinations, where component ratings need only be assigned for those areas included within the examination's scope. In those cases, component ratings should be assigned as the targeted examinations are completed. When an institution's trust activities are examined as a series of limited reviews over a

5. The UITRS was developed by the Federal Financial Institutions Examination Council. SR-98-37 mandated the use of UITRS for Federal Reserve examinations of fiduciary activities.

6. See 63 *Fed. Reg.* 54704 (October 13, 1998).

period of time, the full UITRS rating should be assigned when the examination is considered complete, or at least as often as required under SR-01-05.

Additional Considerations for Specific UITRS Components

Management

The revised UITRS puts greater emphasis on assessing the quality of an institution's risk management, consistent with guidance previously provided to Federal Reserve examiners in SR-96-10. Examiners should continue to include in risk profiles and risk-management assessments the key risks outlined in SR-95-51, including reputation risk, operational risk, legal risk, credit risk, market risk, and liquidity risk. See also SR-16-11. Whether all of these risks or a subset of them is relevant to the assessment of risk management, and thus to the management rating, depends on the scope of the particular institution's fiduciary activities. The other four UITRS rating components may also include consideration of the institution's ability to manage some or all of these risks.

Earnings

Examiners must *evaluate* earnings for all institutions that exercise fiduciary powers. In addition, an earnings *rating* must be assigned for institutions that, at the time of the examination, have total fiduciary assets of more than $100 million and for all nondeposit trust companies. For all other institutions, examiners are not required to assign a rating and should only do so in cases where fiduciary activities are significant and the earnings rating would be meaningful to the overall rating. In these cases, examiners should use the standard earnings-rating definition, rather than the alternate-rating definitions provided in the UITRS. For examinations where no earnings rating is assigned, a rating of 0 should be given for the earnings component, and this component should be excluded from consideration in the composite rating.

Earnings ratings of 3 or worse should be reserved for institutions whose earnings performance indicates a supervisory problem requiring corrective action, which, if left unaddressed, may pose a risk to the institution. Federal Reserve examiners may, therefore, assign an earnings rating of 2 for an institution that has experienced losses in its fiduciary activities, provided that (1) management has determined that there are benefits to the overall institution or its community from offering fiduciary services, (2) losses from fiduciary activities are stable and consistent with management expectations, and (3) such losses do not have a significant adverse effect on the profitability of the institution as a whole.

Asset Management

As noted in the UITRS, the asset-management component may not be applicable for some institutions because their activities do not involve the management of discretionary assets. A rating for asset management may, therefore, be omitted for examinations of institutions whose operations are limited to activities such as directed-agency relationships, securities clearing, nonfiduciary custody relationships, or transfer-agent or registrar activities. However, this component rating should be assigned for an institution that provides investment advice, even though it does not have discretion over the account assets. Where an asset-management rating is not assigned for a particular examination, a rating of 0 should be given, and this component should be excluded from consideration in the composite rating.

Examination Reports

SR-96-26 requires that the UITRS rating be disclosed to the institution in the summary section of each examination report. In addition, the individual numerical component ratings, which should also be disclosed in the open section of the report, may be included in the summary section. If the component ratings are included in the summary section, the ratings should also be included in the open-section pages of the report in which trust findings are presented. If the Reserve Bank prefers not to disclose the examiner's evaluation of the component ratings to the institution, this information may be included in the confidential section of the report. Regardless of where in the report it appears, the evaluation must include sufficient detail to justify the rating assigned.

UITRS Description

Under the UITRS, the fiduciary activities of financial institutions are assigned a composite rating based on an evaluation and rating of five essential components of an institution's fiduciary activities. Composite and component ratings are assigned based on a 1-to-5 numerical scale. A 1 is the highest rating and indicates the strongest performance and risk-management practices and the least degree of supervisory concern. A 5 is the lowest rating and indicates the weakest performance and risk-management practices and, therefore, the highest degree of supervisory concern. The evaluation of the composite and components considers the size and sophistication, the nature and complexity, and the risk profile of the institution's fiduciary activities.

The composite rating generally bears a close relationship to the component ratings assigned. However, the composite rating is not derived by computing an arithmetic average of the component ratings. Each component rating is based on a qualitative analysis of the factors that make up a particular component and on its interrelationship with the other components. When assigning a composite rating, some components may be given more weight than others depending on the situation at the institution. In general, the assignment of a composite rating may incorporate any factor that bears significantly on the overall administration of the financial institution's fiduciary activities. Assigned composite and component ratings are disclosed to the institution's board of directors and senior management.

Management's ability to respond to changing circumstances and address the risks that may arise from changing business conditions, or from the initiation of new fiduciary activities or products, is an important factor in evaluating an institution's overall fiduciary-risk profile and the level of supervisory attention warranted. For this reason, the management component is given special consideration when assigning a composite rating.

The ability of management to identify, measure, monitor, and control the risks of its fiduciary operations is also taken into account when assigning each component rating. It is recognized, however, that appropriate management practices may vary considerably among financial institutions, depending on the size, complexity, and risk profiles of their fiduciary activities. For less complex institutions engaged solely in traditional fiduciary activities and whose directors and senior managers are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. On the other hand, at more complex institutions, detailed and formal management systems and controls are needed to address a broader range of activities and to provide senior managers and directors with the information they need to supervise day-to-day activities.

All institutions are expected to properly manage their risks. For less complex institutions engaging in less risky activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.

Composite Ratings

Composite ratings are based on a careful evaluation of how an institution conducts its fiduciary activities. The review encompasses the capability of management, the soundness of policies and practices, the quality of service rendered to the public, and the effect of fiduciary activities on the soundness of the institution. The composite ratings are defined as follows.

Composite 1

Administration of fiduciary activities is sound in every respect. Generally, all components are rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by management. The institution is in substantial compliance with fiduciary laws and regulations. Risk-management practices are strong relative to the size, complexity, and risk profile of the institution's fiduciary activities. Fiduciary activities are conducted in accordance with sound fiduciary principles and give no cause for supervisory concern.

Composite 2

Administration of fiduciary activities is fundamentally sound. Generally, no component rating should be more severe than 3. Only moderate weaknesses are present and are well within management's capabilities and willingness to correct. Fiduciary activities are conducted in substantial compliance with laws and regulations. Overall risk-management practices are satisfactory relative to the institution's size, complexity, and risk profile. There are no material supervisory concerns and, as a result, the supervisory response is informal and limited.

Composite 3

Administration of fiduciary activities exhibits some degree of supervisory concern in one or more of the component areas. A combination of weaknesses exists that may range from moderate to severe; however, the magnitude of the deficiencies generally does not cause a component to be rated more severely than 4. Management may lack the ability or willingness to effectively address weaknesses within appropriate time frames. Additionally, fiduciary activities may reveal some significant noncompliance with laws and regulations. Risk-management practices may be less than satisfactory relative to the institution's size, complexity, and risk profile. Although problems of relative significance may exist, they are not of such importance as to pose a threat to the trust beneficiaries generally or to the soundness of the institution. The institution's fiduciary activities require more-than-normal supervision and may include formal or informal enforcement actions.

Composite 4

Fiduciary activities generally exhibit unsafe and unsound practices or conditions, resulting in unsatisfactory performance. The problems range from severe to critically deficient and may be centered around inexperienced or inattentive management, weak or dangerous operating practices, or an accumulation of unsatisfactory features of lesser importance. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. There may be significant noncompliance with laws and regulations. Risk-management practices are generally unacceptable relative to the size, complexity, and risk profile of fiduciary activities. These problems pose a threat to the account beneficiaries generally and, if left unchecked, could evolve into conditions that could cause significant losses to the institution and ultimately undermine public confidence in the institution. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems.

Composite 5

Fiduciary activities are conducted in an extremely unsafe and unsound manner. Administration of fiduciary activities is critically deficient in numerous major respects, with problems resulting from incompetent or neglectful administration, flagrant or repeated disregard for laws and regulations, or a willful departure from sound fiduciary principles and practices. The volume and severity of problems are beyond management's ability or willingness to control or correct. Such conditions evidence a flagrant disregard for the interests of the beneficiaries and may pose a serious threat to the soundness of the institution. Continuous close supervisory attention is warranted and may include termination of the institution's fiduciary activities.

Component Ratings

The five key components used to assess an institution's fiduciary activities are (1) the capability of management; (2) the adequacy of operations, controls, and audits; (3) the quality and level of earnings; (4) compliance with governing instruments, applicable law (including self-dealing and conflicts-of-interest laws and regulations), and sound fiduciary principles; and (5) the management of fiduciary assets. Each of the component-rating descriptions is divided into three sections: a narrative description of the component, a list of the principal factors used to evaluate that component, and a description of each numerical rating for that component. Some of the evaluation factors are repeated under one or more of the other components to reinforce the interrelationship among components.

Management

The management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of an institution's fiduciary activities. The rating also reflects the ability of the board of directors and management to ensure that the institution's fiduciary activities are conducted in a safe and sound manner and in compliance with applicable laws and regulations. Directors should provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices are established and followed. Senior fiduciary management is responsible for developing and implementing policies, procedures, and practices that translate the board's objectives and risk limits into prudent operating standards.

Depending on the nature and scope of an institution's fiduciary activities, management practices may need to address some or all of the following risks: reputation, operating or transaction, strategic, compliance, legal, credit, market, liquidity, and other risks. Sound management practices are demonstrated by active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls that consider the size and complexity of the institution's fiduciary activities; and effective risk-monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of fiduciary activities in which the institution is involved.

The management rating is based on an assessment of the capability and performance of management and the board of directors, including, but not limited to, the following evaluation factors:

- the level and quality of oversight and support of fiduciary activities by the board of directors and management, including committee structure and adequate documentation of committee actions
- the ability of the board of directors and management, in their respective roles, to plan for and respond to risks that may arise from changing business conditions or the introduction of new activities or products
- the adequacy of and conformance with appropriate internal policies, practices, and controls addressing the operations and risks of significant fiduciary activities
- the accuracy, timeliness, and effectiveness of management information and risk-monitoring systems appropriate for the institution's size, complexity, and fiduciary-risk profile
- the overall level of compliance with laws, regulations, and sound fiduciary principles
- responsiveness to recommendations from auditors and regulatory authorities
- strategic planning for fiduciary products and services
- the level of experience and competence of fiduciary management and staff, including issues relating to turnover and succession planning
- the adequacy of insurance coverage
- the availability of competent legal counsel
- the extent and nature of pending litigation associated with fiduciary activities, and its potential impact on earnings, capital, and the institution's reputation
- the process for identifying and responding to fiduciary-customer complaints.

Ratings of management. A rating of 1 indicates strong performance by management and the board of directors and strong risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled. Management and the board are proactive and have demonstrated the ability to promptly and successfully address existing and potential problems and risks.

A rating of 2 indicates satisfactory management and board performance and risk-management practices relative to the size, complexity, and risk profile of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material to the sound administration of fiduciary activities and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates management and board performance that needs improvement or risk-management practices that are less than satisfactory given the nature of the institution's fiduciary activities. The capabilities of management or the board of directors may be insufficient for the size, complexity, and risk profile of the institution's fiduciary activities. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient management and board performance or risk-management practices that are inadequate considering the size, complexity, and risk profile of the institution's fiduciary activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action by the board and management to protect the assets of account beneficiaries and to prevent erosion of public confidence in the institution. Replacing or strengthening management or the board may be necessary.

A rating of 5 indicates critically deficient management and board performance or risk-management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk-management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution or its administration of fiduciary activities, and they pose a threat to the safety of the assets of account beneficiaries. Replacing or strengthening management or the board of directors is necessary.

Operations, Internal Controls, and Auditing

The operations, internal controls, and auditing rating reflects the adequacy of the institution's fiduciary operating systems and internal controls in relation to the volume and character of business conducted. Audit coverage must ensure the integrity of the financial records, the sufficiency of internal controls, and the adequacy of the compliance process.

Fiduciary operating systems, internal controls, and the audit function subject an institution primarily to transaction and compliance risk. Other risks, including reputation, strategic, and financial risk, also may be present. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The operations, internal controls, and auditing rating is based on, but not limited to, an assessment of the following evaluation factors:

- operations and internal controls, including the adequacy of—
  - — staff, facilities, and operating systems;
  - — records, accounting, and data processing systems (including controls over systems access and such accounting procedures as aging, investigation, and disposition of items in suspense accounts);
  - — trading functions and securities-lending activities;
  - — vault controls and securities movement;
  - — segregation of duties;
  - — controls over disbursements (checks or electronic) and unissued securities;
  - — controls over income-processing activities; and
  - — reconciliation processes (depository, cash, vault, subcustodians, suspense accounts, etc.)
- disaster or business-recovery programs—
  - — hold-mail procedures and controls over returned mail, and
  - — investigation and proper escheatment of funds in dormant accounts
- auditing, including—
  - — the independence, frequency, quality, and scope of the internal and external fiduciary-audit function relative to the volume, character, and risk profile of the institution's fiduciary activities;
  - — the volume or severity of internal-control and audit exceptions and the extent to which these issues are tracked and resolved; and
  - — the experience and competence of the audit staff.

Ratings of operations, internal controls, and auditing. A rating of 1 indicates that operations, internal controls, and auditing are strong in relation to the volume and character of the institution's fiduciary activities. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates that operations, internal controls, and auditing are satisfactory in relation to the volume and character of the institution's fiduciary activities. Moderate weaknesses may exist, but are not material. Significant risks, in general, are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates that operations, internal controls, or auditing need improvement in relation to the volume and character of the institution's fiduciary activities. One or more of these areas are less than satisfactory. Problems and significant risks may be inadequately identified, measured, monitored, or controlled.

A rating of 4 indicates deficient operations, internal controls, or audits. One or more of these areas are inadequate or the level of problems and risk exposure is excessive in relation to the volume and character of the institution's fiduciary activities. Problems and significant risks are inadequately identified, measured, monitored, or controlled and require immediate action. Institutions with this level of deficiencies may make little provision for audits, or they may evidence weak or potentially dangerous operating practices in combination with infrequent or inadequate audits.

A rating of 5 indicates critically deficient operations, internal controls, or audits. Operating practices, with or without audits, pose a serious threat to the safety of assets of fiduciary accounts. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of the institution to continue engaging in fiduciary activities.

Earnings

The earnings rating reflects the profitability of an institution's fiduciary activities and their effect on the financial condition of the institution. The use and adequacy of budgets and earnings projections by functions, product lines, and clients are reviewed and evaluated. Risk exposure that may lead to negative earnings is also evaluated.

An evaluation of earnings is required for all institutions with fiduciary activities. An assignment of an earnings rating, however, is required only for institutions that, at the time of the examination, have total trust assets of more than $100 million or that are a nondeposit trust company.

The evaluation of earnings is based on, but not limited to, an assessment of the following factors:

- the profitability of fiduciary activities in relation to the size and scope of those activities and to the overall business of the institution
- the overall importance to the institution of offering fiduciary services to its customers and local community
- the effectiveness of the institution's procedures for monitoring fiduciary-activity income and expense relative to the size and scope of these activities and their relative importance to the institution, including the frequency and scope of profitability reviews and planning by the institution's board of directors or a committee thereof

For those institutions for which a rating of earnings is mandatory, additional factors should include the following:

- the level and consistency of profitability, or the lack thereof, generated by the institution's fiduciary activities in relation to the volume and character of the institution's business
- dependence on nonrecurring fees and commissions, such as fees for court accounts
- the effects of charge-offs or compromise actions
- unusual features regarding the composition of business and fee schedules
- accounting practices that contain practices such as (1) unusual methods of allocating direct and indirect expenses and overhead, or (2) unusual methods of allocating fiduciary income and expense where two or more fiduciary institutions within the same holding company family share fiduciary services or processing functions
- the extent of management's use of budgets, projections, and other cost-analysis procedures
- methods used for directors' approval of financial budgets or projections
- management's attitude toward growth and new-business development
- new-business development efforts, including types of business solicited, market potential, advertising, competition, relationships with local organizations, and an evaluation by management of the risk potential inherent in new business areas

Ratings of earnings. A rating of 1 indicates strong earnings. The institution consistently earns a rate of return on its fiduciary activities that is commensurate with the risk of those activities. This rating would normally be supported by a history of consistent profitability over time and a judgment that future earnings prospects are favorable. In addition, management techniques for evaluating and monitoring earnings performance are fully adequate, and there is appropriate oversight by the institution's board of directors or a committee thereof. Management makes effective use of budgets and cost-analysis procedures. Methods used for reporting earnings information to the board of directors, or a committee thereof, are comprehensive.

A rating of 2 indicates satisfactory earnings. Although the earnings record may exhibit some weaknesses, earnings performance does not pose a risk to the overall institution nor to its ability to meet its fiduciary obligations. Generally, fiduciary earnings meet management targets and appear to be at least sustainable. Management processes for evaluating and monitoring earnings are generally sufficient in relationship to the size and risk of fiduciary activities that exist, and any deficiencies can be addressed in the normal course of business. A rating of 2 may also be assigned to institutions with a history of profitable operations if there are indications that management is engaging in activities with which it is not familiar or where there may be inordinately high levels of risk present that have not been adequately evaluated. Alternatively, an institution with otherwise strong earnings performance may also be assigned a 2 rating if there are significant deficiencies in its methods used to monitor and evaluate earnings.

A rating of 3 indicates less-than-satisfactory earnings. Earnings are not commensurate with the risk associated with the fiduciary activities undertaken. Earnings may be erratic or exhibit downward trends, and future prospects are unfavorable. This rating may also be assigned if management processes for evaluating and monitoring earnings exhibit serious deficiencies, provided the deficiencies identified do not pose an immediate danger to either the overall financial condition of the institution or its ability to meet its fiduciary obligations.

A rating of 4 indicates earnings that are seriously deficient. Fiduciary activities have a significant adverse effect on the overall income of the institution and its ability to generate adequate capital to support the continued operation of its fiduciary activities. The institution is characterized by fiduciary earnings performance that is poor historically or that faces the prospect of significant losses in the future. Management processes for monitoring and evaluating earnings may be poor. The board of directors has not adopted appropriate measures to address significant deficiencies.

A rating of 5 indicates critically deficient earnings. In general, an institution with this rating is experiencing losses from fiduciary activities that have a significant negative impact on the overall institution, representing a distinct threat to its viability through the erosion of its capital. The board of directors has not implemented effective actions to address the situation.

Alternate rating of earnings. The UITRS alternate rating of earnings is *not* for use by Federal Reserve System examiners, per the December 1998 Federal Reserve UITRS implementing guidelines. For institutions where the assignment of an earnings rating is not required by the UITRS, an FFIEC federal supervisory agency has the option to assign an earnings rating using an alternate set of ratings. The alternate ratings are provided here so examiners will be able to interpret earnings ratings assigned by other banking supervisors that have adopted the alternate-rating system for earnings. Under the alternate-ratings scheme, alternate ratings are assigned based on the level of implementation of four minimum standards by the board of directors and management:

- *Standard No. 1.* The institution has reasonable methods for measuring income and expense commensurate with the volume and nature of the fiduciary services offered.
- *Standard No. 2.* The level of profitability is reported to the board of directors, or a committee thereof, at least annually.
- *Standard No. 3.* The board of directors periodically determines that the continued offering of fiduciary services provides an essential service to the institution's customers or to the local community.
- *Standard No. 4.* The board of directors, or a committee thereof, reviews the justification for the institution to continue to offer fiduciary services, even if the institution does not earn sufficient income to cover the expenses of providing those services.

Ratings to be applied for the alternate rating of earnings. A rating of 1 may be assigned where an institution has implemented all four minimum standards. If fiduciary earnings are lacking, management views this as a cost of doing business as a full-service institution and believes that the negative effects of not offering fiduciary services are more significant than the expense of administrating those services.

A rating of 2 may be assigned where an institution has implemented, at a minimum, three of the four standards. This rating may be assigned if the institution is not generating positive earnings or where formal earnings information may not be available.

A rating of 3 may be assigned if the institution has implemented at least two of the four standards. Although management may have attempted to identify and quantify other revenue to be earned by offering fiduciary services, it has decided that these services should be offered as a service to customers, even if they cannot be operated profitably.

A rating of 4 may be assigned if the institution has implemented only one of the four standards. Management has undertaken little or no effort to identify or quantify the collateral advantages, if any, to the institution from offering fiduciary services.

A rating of 5 may be assigned if the institution has implemented none of the standards.

Compliance

The compliance rating reflects an institution's overall compliance with applicable laws, regulations, accepted standards of fiduciary conduct, governing account instruments, duties associated with account administration, and internally established policies and procedures. This component specifically incorporates an assessment of a fiduciary's duty of undivided loyalty and compliance with applicable laws, regulations, and accepted standards of fiduciary conduct related to self-dealing and other conflicts of interest.

The compliance component includes reviewing and evaluating the adequacy and soundness of adopted policies, procedures, and practices generally and as they relate to specific transactions and accounts. It also includes reviewing policies, procedures, and practices to evaluate the sensitivity of management and the board of directors to refrain from self-dealing, minimize potential conflicts of interest, and resolve actual conflict situations in favor of the fiduciary-account beneficiaries.

Risks associated with account administration are potentially unlimited because each account is a separate contractual relationship that contains specific obligations. Risks associated with account administration include failure to comply with applicable laws, regulations, or terms of the governing instrument; inadequate account-administration practices; and inexperienced management or inadequately trained staff. Risks associated with a fiduciary's duty of undivided loyalty generally stem from engaging in self-dealing or other conflict-of-interest transactions. An institution may be exposed to compliance, strategic, financial, and reputation risk related to account-administration and conflicts-of-interest activities. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating. Policies, procedures, and practices pertaining to account administration and conflicts of interest are evaluated in light of the size and character of an institution's fiduciary business.

The compliance rating is based on, but not limited to, an assessment of the following evaluation factors:

- compliance with applicable federal and state statutes and regulations, including, but not limited to, federal and state fiduciary laws, the Employee Retirement Income Security Act of 1974, federal and state securities laws, state investment standards, state principal and income acts, and state probate codes
- compliance with the terms of governing instruments
- the adequacy of overall policies, practices, and procedures governing compliance, considering the size, complexity, and risk profile of the institution's fiduciary activities
- the adequacy of policies and procedures addressing account administration
- the adequacy of policies and procedures addressing conflicts of interest, including those designed to prevent the improper use of "material inside information"
- the effectiveness of systems and controls in place to identify actual and potential conflicts of interest
- the adequacy of securities-trading policies and practices relating to the allocation of brokerage business; the payment of services with "soft dollars"; and the combining, crossing, and timing of trades
- the extent and permissibility of transactions with related parties, including, but not limited to, the volume of related commercial and fiduciary relationships and holdings of corporations in which directors, officers, or employees of the institution may be interested
- the decision-making process used to accept, review, and terminate accounts
- the decision-making process related to account-administration duties, including cash balances, overdrafts, and discretionary distributions

Ratings of compliance. A rating of 1 indicates strong compliance policies, procedures, and practices. Policies and procedures covering conflicts of interest and account administration are appropriate in relation to the size and complexity of the institution's fiduciary activities. Accounts are administered in accordance with governing instruments, applicable laws and regulations, sound fiduciary principles, and internal policies and procedures. Any violations are isolated, technical in nature, and easily correctable. All significant risks are consistently and effectively identified, measured, monitored, and controlled.

A rating of 2 indicates fundamentally sound compliance policies, procedures, and practices in relation to the size and complexity of the institution's fiduciary activities. Account administration may be flawed by moderate weaknesses in policies, procedures or practices. Management's practices indicate a determination to minimize the instances of conflicts of interest. Fiduciary activities are conducted in substantial compliance with laws and regulations, and any violations are generally technical in nature. Management corrects violations in a timely manner and without loss to fiduciary accounts. Significant risks are effectively identified, measured, monitored, and controlled.

A rating of 3 indicates compliance practices that are less than satisfactory in relation to the size and complexity of the institution's fiduciary activities. Policies, procedures, and controls have not proven effective and require strengthening. Fiduciary activities may be in substantial noncompliance with laws, regulations, or governing instruments, but losses are no worse than minimal. Although management may have the ability to achieve compliance, the number of violations that exist, or the failure to correct prior violations, is an indication that management has not devoted sufficient time and attention to its compliance responsibilities. Risk-management practices generally need improvement.

A rating of 4 indicates an institution with deficient compliance practices in relation to the size and complexity of its fiduciary activities. Account administration is notably deficient. The institution makes little or no effort to minimize potential conflicts or refrain from self-dealing, and it is confronted with a considerable number of potential or actual conflicts. Numerous substantive and technical violations of laws and regulations exist, and many may remain uncorrected from previous examinations. Management has not exerted sufficient effort to effect compliance and may lack the ability to effectively administer fiduciary activities. The level of compliance problems is significant and, if left unchecked, may subject the institution to monetary losses or reputation risk. Risks are inadequately identified, measured, monitored, and controlled.

A rating of 5 indicates critically deficient compliance practices. Account administration is critically deficient or incompetent, and there is a flagrant disregard for the terms of the governing instruments and interests of account beneficiaries. The institution frequently engages in transactions that compromise its fundamental duty of undivided loyalty to account beneficiaries. There are flagrant or repeated violations of laws and regulations and significant departures from sound fiduciary principles. Management is unwilling or unable to operate within the scope of laws and regulations or within the terms of governing instruments, and efforts to obtain voluntary compliance have been unsuccessful. The severity of noncompliance presents an imminent monetary threat to account beneficiaries and creates significant legal and financial exposure to the institution. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the ability of management to continue engaging in fiduciary activities.

Asset Management

The asset-management rating reflects the risks associated with managing the assets (including cash) of others. Prudent portfolio management is based on an assessment of the needs and objectives of each account or portfolio. An evaluation of asset management should consider the adequacy of processes related to the investment of all discretionary accounts and portfolios, including collective investment funds, proprietary mutual funds, and investment advisory arrangements.

The institution's asset-management activities subject it to reputation, compliance, and strategic risks. In addition, each individual account or portfolio managed by the institution is subject to financial risks such as market, credit, liquidity, and interest-rate risk, as well as transaction and compliance risk. The ability of management to identify, measure, monitor, and control these risks is reflected in this rating.

The asset-management rating is based on, but not limited to, an assessment of the following evaluation factors:

- the adequacy of overall policies, practices, and procedures governing asset management, considering the size, complexity, and risk profile of the institution's fiduciary activities

- the decision-making processes used for selection, retention, and preservation of discretionary assets, including adequacy of documentation, committee review and approval, and a system to review and approve exceptions
- the use of quantitative tools to measure the various financial risks in investment accounts and portfolios
- the existence of policies and procedures addressing the use of derivatives or other complex investment products
- the adequacy of procedures related to the purchase or retention of miscellaneous assets, including real estate, notes, closely held companies, limited partnerships, mineral interests, insurance, and other unique assets
- the extent and adequacy of periodic reviews of investment performance, taking into consideration the needs and objectives of each account or portfolio
- the monitoring of changes in the composition of fiduciary assets for trends and related risk exposure
- the quality of investment research used in the decision-making process and documentation of the research
- the due-diligence process for evaluating investment advice received from vendors or brokers (including approved or focus lists of securities)
- the due-diligence process for reviewing and approving brokers or counterparties used by the institution

This rating may not be applicable for some institutions because their operations do not include activities involving the management of any discretionary assets. Functions of this type would include, but not necessarily be limited to, directed-agency relationships, securities clearing, nonfiduciary custody relationships, and transfer-agent and registrar activities. In institutions of this type, the rating for asset management may be omitted by the examiner in accordance with the examining agency's implementing guidelines. However, this component should be assigned when the institution provides investment advice, even though it does not have discretion over the account assets. An example of this type of activity would be where the institution selects or recommends the menu of mutual funds offered to participant-directed 401(k) plans.

Ratings of asset management. A rating of 1 indicates strong asset-management practices. Identified weaknesses are minor in nature. Risk exposure is modest in relation to management's abilities and the size and complexity of the assets managed.

A rating of 2 indicates satisfactory asset-management practices. Moderate weaknesses are present and are well within management's ability and willingness to correct. Risk exposure is commensurate with management's abilities and the size and complexity of the assets managed. Supervisory response is limited.

A rating of 3 indicates that asset-management practices are less than satisfactory in relation to the size and complexity of the assets managed. Weaknesses may range from moderate to severe; however, they are not of such significance as to generally pose a threat to the interests of account beneficiaries. Asset-management and risk-management practices generally need to be improved. An elevated level of supervision is normally required.

A rating of 4 indicates deficient asset-management practices in relation to the size and complexity of the assets managed. The levels of risk are significant and inadequately controlled. The problems pose a threat to account beneficiaries generally and, if left unchecked, may subject the institution to losses and could undermine the reputation of the institution.

A rating of 5 represents critically deficient asset-management practices and a flagrant disregard of fiduciary duties. These practices jeopardize the interests of account beneficiaries, subject the institution to losses, and may pose a threat to the soundness of the institution.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Trust

The role of bank regulators in supervising private-banking activities is (1) to evaluate management's ability to measure and control the risks associated with such activities and (2) to determine if the proper internal control and audit infrastructures are in place to support effective compliance with relevant laws and regulations. In this regard, the supervisors may determine that certain risks have not been identified or adequately managed by the institution, a potentially unsafe and unsound banking practice.

Private-banking functions may be performed in a specific department of a commercial bank, an Edge corporation or its foreign subsidiaries, a nonbank subsidiary, a branch or agency of a foreign banking organization, or multiple areas of an institution. Private banking may also be the sole business of an institution. Regardless of how an institution is organized or where it is located, the results of the private-banking review should be reflected in the entity's overall supervisory assessment.[1]

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of financial institutions. It is intended to supplement, not replace, existing guidance on the examination of private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. In addition to providing an overview of private banking, the general types of customers, and the various products and services typically provided, the ''Functional Review'' subsection describes the critical functions that constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance. Included in the risk-management portion is a discussion of the basic ''customer-due-diligence'' (CDD) principle that is the foundation for the safe and sound operation of a private-banking business. The ''Preparation for Examination'' subsection assists in defining the examination scope and provides a list of core requests to be made in the first-day letter. Additional examination guidance can be found in this manual, the Federal Financial Institutions Examination Council's (FFIEC) *Bank Secrecy Act/Anti-Money Laundering (BSA/AML) Examination Manual*, the Federal Reserve System's *Trading and Capital-Markets Activities Manual,* and the FFIEC *Information Technology Examination Infobase*.

In reviewing specific functional and product-examination procedures (as found in the private-banking activities module that is part of the framework for risk-focused supervision of large complex institutions), all aspects of the private-banking review should be coordinated with the rest of the examination to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of products generated by other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines.

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to an affluent market, primarily to high net worth individuals and their corporate interests. A private-banking operation typically offers its customers an all-inclusive money-management relationship, including investment portfolio management, financial-planning advice, offshore facilities, custodial services, funds transfer, lending services, overdraft privileges, hold mail, letter-of-credit financing, and bill-paying services. As the affluent market grows, both in the United States and globally, competition to serve it is becoming more intense. Consequently, the private-banking marketplace includes banks, nonbanks, and other types of banking organizations and financial institutions. Private-banking products, services, technologies, and distribution channels are still evolving. A range of private-banking products and services may be offered to customers throughout an institution's global network of affiliated entities—including branches, subsidi-

1. Throughout this section, the word *bank* will be used to describe all types of financial institutions, and the term *board of directors* will be interchangeable with *senior management* of branches and agencies of foreign banks.

aries, and representative offices—in many different regions of the world, including offshore secrecy jurisdictions.

Typically, private-banking customers are high net worth individuals or institutional investors who have minimum investible assets of $1 million or more. Institutions often differentiate domestic from international private banking, and they may further segregate the international function on the basis of the geographic location of their international client base. International private-banking clients may be wealthy individuals who live in politically unstable nations and are seeking a safe haven for their capital. Therefore, obtaining detailed background information and documentation about the international client may be more difficult than it is for the domestic customer. Private-banking accounts may, for example, be opened in the name of an individual, a commercial business, a law firm, an investment adviser, a trust, a personal investment company (PIC), or an offshore mutual fund.

In 2001, the USA PATRIOT Act (the Patriot Act) established new and enhanced measures to prevent, detect, and prosecute money laundering and terrorist financing. In general, these measures were enacted through amendments to the Bank Secrecy Act (BSA). The measures directly affecting banking organizations are implemented primarily through regulations issued by the U.S. Department of the Treasury (31 CFR 1010).[2] Section 326 of the Patriot Act (see the BSA at 31 USC 5318(*l*)) requires financial institutions (such as banks, savings associations, and credit unions) to have customer identification programs.

A customer identification program is dependent on whether an account has been created. An "account" is defined in the CIP rule as "a formal banking relationship established to provide or engage in services, dealings, or other financial transactions, including a deposit account, a transaction or asset account, a credit account or other extension of credit." An account also includes "a relationship established to provide a safety deposit box or other safekeeping services or to provide cash management, custodian, or trust services."[3] Under the CIP rule, a person that opens a new account is deemed a customer.[4] An account *does not include*:

- "products and services for which a formal banking relationship is not generally established with a person, such as check cashing, wire transfer, or the sale of a check or money order" or
- any account that the bank acquires, or accounts opened, to participate in an employee benefit plan established under the Employee Retirement Income Security Act of 1974.

(Refer to SR-16-7 and its interagency attachment.) Customer identification programs are to include measures to—

- require that certain information be obtained at account opening (for individuals, the information would generally include their name, address, tax identification number, and date of birth);
- verify the identity of new account holders within a reasonable time period;
- ensure that a banking organization has a reasonable belief that it knows each customer's identity;
- maintain records of the information used to verify a person's identity; and
- compare the names of new customers against government lists of known or suspected terrorists or terrorist organizations.

A customer identification program is an important component of a financial institution's overall anti-money-laundering and BSA compliance program.

The FFIEC *BSA/AML Examination Manual* provides the interagency BSA examination procedures that should be used to evaluate banking organizations' compliance with the regulation. The examination's scope can be tailored to the reliability of the banking organization's compliance-management system and to the level of risk that the organization assumes. Relevant interagency guidance (in a frequently-asked-question format) has been issued to address the customer identification program rules. (See SR-05-9.)

2. For banking organizations, the regulation implementing the requirements of section 326 of the Patriot Act was jointly issued by the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

3. 31 CFR 1020.100 (a)(1).

4. 31 CFR 1020.100(c)(1)(i).

Private-banking accounts are usually generated on a referral basis. Every client of a private-banking operation is assigned a salesperson or marketer, commonly known as a relationship manager (RM), as the primary point of contact with the institution. The RM is generally charged with understanding and anticipating the needs of his or her wealthy clients and then recommending services and products for them. The number of accounts an RM handles varies, depending on the portfolio size or net worth of the particular accounts. RMs strive to provide a high level of support, service, and investment opportunities to their clients and tend to maintain strong, long-term client relationships. Frequently, RMs take accounts with them to other private-banking institutions if they change employment. Historically, initial and ongoing due diligence of private-banking clients is not always well documented in the institution's files because of RM turnover and confidentiality concerns.

Clients may choose to delegate a great deal of authority and discretion over their financial affairs to RMs. Given the close relationship between clients and their account officers, an integral part of the examination process is assessing the adequacy of managerial oversight of the nature and volume of transactions conducted within the private-banking department or with other departments of the financial institution, as well as determining the adequacy and integrity of the RM's procedures. Policy guidelines and management supervision should provide parameters for evaluating the appropriateness of all products, especially those involving market risk. Moreover, because of the discretion given to RMs, management should develop effective procedures to review the activity of client accounts in order to protect the client from any unauthorized activity. In addition, ongoing monitoring of account activity should be conducted to detect activity that is inconsistent with the client profile (for example, frequent or sizable unexplained transfers flowing through the account).

Finally, as clients develop a return-on-assets (ROA) outlook to enhance their returns, the use of leveraging and arbitrage is becoming more evident in the private-banking business. Examiners should be alert to the totality of the client relationship product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

Products and Services

Personal Investment Companies, Offshore Trusts, and Token-Name Accounts

Private-banking services almost always involve a high level of confidentiality for clients and their account information. Consequently, it is not unusual for private bankers to help their clients achieve their financial-planning, estate-planning, and confidentiality goals through offshore vehicles such as personal investment companies (PICs), trusts, or more-exotic arrangements, such as hedge fund partnerships. While these vehicles may be used for legitimate reasons, without careful scrutiny, they may camouflage illegal activities. Private bankers should be committed to using sound judgment and enforcing prudent banking practices, especially when they are assisting clients in establishing offshore vehicles or token-name accounts.

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening accounts in the PIC's name. The "beneficial owners" of the shell corporations are typically foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. *Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.*

PICs are typically passive personal investment vehicles. However, foreign nationals have established PICs as operating accounts for business entities they control in their home countries. Accordingly, financial institutions should use extra care when dealing with beneficial owners of PICs and associated trusts; these vehicles can be used to conceal illegal activities.

Deposit Taking

A client's private-banking relationship frequently begins with a deposit account and then expands into other products. In fact, many institutions require private-banking customers to establish a deposit account before maintaining any other accounts. Deposit accounts serve as conduits for a client's money flows. To distinguish private-banking accounts from retail accounts, institutions usually require significantly higher minimum account balances and assess higher fees. The private-banking function or institution should have account-opening procedures and documentation requirements that must be fulfilled before a deposit account can be opened. (These standards are described in detail in the "Functional Review" subsection.)

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). It is very important that the transaction activity into and out of these deposit accounts (including internal transfers between affiliated depository accounts) be closely monitored for suspicious transactions that are inconsistent with the client's profile of usual transactions. Suspicious transactions could warrant the filing of a Suspicious Activity Report for Depository Institutions (SAR) form. A bank holding company or any nonbank subsidiary thereof, or a foreign bank that is subject to the Bank Holding Company Act (or any nonbank subsidiary of such a foreign bank operating in the United States), is required to file a SAR form in accordance with the provision of section 208.62 of the Federal Reserve Board's Regulation H (12 CFR 208.62) when suspicious transactions or activities are initially discovered and warrant or require reporting. See the expanded procedures for private banking in the FFIEC's *BSA/AML Examination Manual.*

On March 15, 2006, the Board approved a revision to Regulation K (effective April 19, 2006) that incorporates by reference into sections 211.5 and 211.24 of Regulation K section 208.63 of Regulation H. The incorporation results in the requirement that Edge and agreement corporations and other foreign banking organizations (that is, Federal Reserve supervised U.S. branches, agencies, and representative offices of foreign banks) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the BSA and related regulations. Each of these banking organizations' compliance programs must include, at a minimum (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance, and (4) training for appropriate personnel. (See SR-06-7.)

Investment Management

In private banking, investment management usually consists of two types of accounts: (1) discretionary accounts in which portfolio managers make the investment decisions on the basis of recommendations from the bank's investment research resources and (2) nondiscretionary (investment advisory) accounts in which clients make their own investment decisions when conducting trades. For nondiscretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Discretionary accounts consist of a mixture of instruments bearing varying degrees of market, credit, and liquidity risk that should be appropriate to the client's investment objectives and risk appetite. Both account types are governed under separate agreements between the client and the institution.

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated according to the customer who owns the assets.

Credit

Private-banking clients may request extensions of credit on either a secured or an unsecured basis. Loans backed by cash collateral or managed assets held by the private-banking function are quite common, especially in international private banking. Private-banking clients may pledge a wide range of their assets, including cash, mortgages, marketable securities, land, or buildings, to securitize their loans. Management should demonstrate an understanding of the purpose of the credit, the source of repayment, the loan tenor, and the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or an unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured customer-due-diligence process. If that process is not thorough, collateral derived from illicit activities may be subject to government forfeiture.

Borrowing mechanisms are sometimes established to afford nonresident-alien customers the ability to keep financial assets in the United States and to use such assets (via collateralized borrowing arrangements) to provide operating capital for businesses they own and operate in their home countries. Such arrangements enable these customers to keep the existence of the financial assets secret from their home-country authorities and others, while they continue to use the funds (via collateralized borrowings) to fund the businesses at home.

Private bankers need to maintain in the United States adequate CDD information on such nonresident-alien customers and their primary business interests. A well-documented CDD file may include information on the customer from "who's who" and similar services, Internet research, foreign tax returns and financial statements, checks conducted by the Office of Foreign Assets Control (OFAC), and written and appropriately documented Call Reports prepared by the RM.

While these lending mechanisms may be used for legitimate reasons, management needs to determine whether the arrangements are being used primarily to obfuscate the beneficial ownership of collateral assets, making it difficult for the customer's home-country government to identify who owns the assets. If so, management needs to further determine whether the practice varies from both the appropriate standards of international cooperation for transparency issues and with prudent banking practices, and if so, whether the institution is exposed to elevated legal risk.

Payable-Through Accounts

Another product that may be available in private-banking operations is payable-through accounts (PTAs). PTAs are transaction deposit accounts through which U.S. banking entities ("payable-through banks") extend check-writing privileges to the customers of a foreign bank. The foreign bank ("master account holder") opens a master checking account with the U.S. bank and uses this account to provide its customers with access to the U.S. banking system. The master account is divided into "subaccounts," each in the name of one of the foreign bank's customers. The foreign bank extends signature authority on its master account to its own customers, who may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement may be virtually unlimited.

U.S. banking entities engage in PTAs primarily because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank-customer relationship; PTAs also provide substantial fee income. Generally, PTAs at U.S. banking entities have the following characteristics: they are carried on the U.S. banking entity's books as a correspondent bank account, their transaction volume is high, checks passing through the account contain wording similar to "payable through XYZ bank," and the signatures appearing on checks are not those of authorized officers of the foreign bank. See the expanded examination procedures for PTAs in the FFIEC's *BSA/AML Examination Manual.*

Personal Trust and Estates

In trust and estate accounts, an institution offers management services for a client's assets. When dealing with trusts under will, or "testamentary trusts," the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are subject to review by the probate or surrogates' court. On the other hand, with living trusts, or "grantor trusts," the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer's closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks that function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the bank. In these accounts, the bank is the fiduciary and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. Proper administration of trusts and estates includes strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. See the expanded examination procedures for trust and asset-management services in the FFIEC's *BSA/AML Examination Manual.*

Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipt and disbursement of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the bank or from outside investment advisers. The customer or a designated financial adviser retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, procedures for proper administration should be established and reviewed.

An escrow account is a form of custody account in which the institution agrees to hold cash or securities as a middleman, or a third party. The customer, for example, an attorney or a travel agency, gives the institution funds to hold until the ultimate receiver of the funds "performs" in accordance with the written escrow agreement, at which time the institution releases the funds to the designated party.

Funds Transfer

Funds transfer, another service offered by private-banking functions, may involve the transfer of funds between third parties as part of bill-paying and investment services on the basis of customer instructions. The adequacy of controls over funds-transfer instructions that are initiated electronically or telephonically is extremely important. Funds-transfer requests are quickly processed and, as required by law, funds-transfer personnel may have limited knowledge of the customers or the purpose of the transactions. Therefore, strong controls and adequate supervision over this area are critical. See section 4063.1.

Hold Mail, No Mail, and Electronic-Mail Only

Hold-mail, no-mail, or electronic-mail-only accounts are often provided to private-banking customers who elect to have bank statements and other documents maintained at the institution rather than mailed to their residence. Agreements for hold-mail accounts should be in place, and the agreements should indicate that it was the customer's choice to have the statements retained at the bank and that the customer will pick up his or her mail at least annually. Variations of hold-mail services include delivery of mail to a prearranged location (such as another branch of the bank) by special courier or the bank's pouch system.

Bill-Paying Services

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the bank and the customer should exist. Typically, a customer may request that the bank debit a deposit account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges. In addition, the increased use of the Internet has given rise to the "electronic-mail-only" account, whereby customers elect to have statements, notices, etc., sent to them only by e-mail.

FUNCTIONAL REVIEW

When discussing the functional aspects of a private-banking operation, *functional* refers to managerial processes and procedures, such as reporting lines, quality of supervision (including involvement of the board of directors), information flows, policies and procedures, risk-management policies and methodologies, segregation of duties, management information systems, operational controls (including BSA/AML monitoring), and audit coverage. The examiner should be able to draw sound conclusions about the quality and culture of management and stated private-banking policies after reviewing the functional areas described below. Specifically, the institution's risk-identification process and risk appetite should be carefully defined and assessed. Additionally, the effectiveness of the overall control environment maintained by management should be evaluated by an internal or external audit. The effectiveness of the following functional areas is critical to any private-banking operation, regardless of its size or product offerings.

Supervision and Organization

As part of the examiner's appraisal of an organization, the quality of supervision of private-banking activities is evaluated. The appraisal of management covers the full range of functions and activities related to the operation of the private bank. The discharge of responsibilities by bank directors should be effected through an organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the institution's private-banking business. Organizational planning is the joint responsibility of senior bank and private-bank management, should be integrated with the long-range plan for the institution, and should be consistent with any enterprise-wide-risk-management program.

Both the directors and management have important roles in formulating policies and establishing programs for private-banking products, operations, internal controls, and audits. However, management alone must implement policies and programs within the organizational framework instituted by the board of directors.

Risk Management

Sound risk-management processes and strong internal controls are critical to safe and sound banking generally and to private-banking activities in particular. Management's role in ensuring the integrity of these processes has become increasingly important as new products and technologies are introduced. Similarly, the client-selection, documentation, approval, and account-monitoring processes should adhere to sound and well-identified practices.

The quality of risk-management practices and internal controls is given significant weight in the evaluation of management and the overall condition of private-banking operations. A bank's failure to establish and maintain a risk-management framework that effectively identifies, measures, monitors, and controls the risks associated with products and services should be considered unsafe and unsound conduct. Furthermore, well-defined management practices should indicate the types of clients that the institution will and will not accept and should establish multiple and segregated levels of authorization for accepting new clients. Institutions that follow sound practices will be better positioned to design and deliver products and services that match their clients' legitimate needs, while reducing the likelihood that unsuitable clients might enter their client account base. Deficiencies noted in this area are weighted in context of the relative risk they pose to the institution and are appropriately reflected in the appraisal of management.

The private-banking function is exposed to a number of risks, including reputational, fiduciary, legal, credit, operational, and market. A brief description of some of the different types of risks follows:

- *Reputational risk* is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions.
- *Fiduciary risk* refers to the risk of loss due to the institution's failure to exercise loyalty;

safeguard assets; and, for trusts, to use assets productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.

- *Legal risk* arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance breakdowns.
- *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

Although effective management of all of the above risks is critical for an institution, certain aspects of reputational, legal, and fiduciary risks are often unique to a private-banking function. In this regard, the following customer-due-diligence policies and practices are essential in the management of reputational and legal risks in the private-banking functions. (In addition, sound fiduciary practices and conflicts-of-interest issues that a private-banking operation may face in acting as fiduciary are described in the subsection on fiduciary standards.)

Customer-Due-Diligence Policy and Procedures

Sound customer-due-diligence (CDD) policies and procedures are essential to minimize the risks inherent in private banking. The policies and procedures should clearly describe the target client base in terms such as “minimum investable net worth” and “types of products sought,” as well as specifically indicate the type of clientele the institution will or will not accept. Policies and procedures should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional CDD information on an ongoing basis, and that activity in client accounts is monitored for transactions that are inconsistent with the client profile and may constitute unlawful activities, such as money laundering. The client’s identity, background, and the nature of his or her transactions should be documented and approved by the back office before opening an account or accepting client monies. Certain high-risk clients like foreign politicians or money exchange houses should have additional documentation to mitigate their higher risk.

Money laundering is associated with a broad range of illicit activities: the ultimate intention is to disguise the money’s true source—from the initial placement of illegally derived cash proceeds to the layers of financial transactions that disguise the audit trail—and make the funds appear legitimate. Under U.S. money-laundering statutes, a bank employee can be held personally liable if he or she is deemed to engage in “willful blindness.” This condition occurs when the employee fails to make reasonable inquiries to satisfy suspicions about client account activities.

Since the key element of an effective CDD policy is a comprehensive knowledge of the client, the bank’s policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. CDD policies should clearly delineate the accountability and authority for opening accounts and for determining if effective CDD practices have been performed on each client. In addition, policies should delineate documentation standards and accountability for gathering client information from referrals among departments or areas within the institution as well as from accounts brought to the institution by new RMs.

In carrying out prudent CDD practices on potential private-banking customers, management should document efforts to obtain and corroborate critical background information. Private-banking employees abroad often have local contacts who can assist in corroborating information received from the customer. The information listed below should be corroborated by a reliable, independent source, when possible:

- The customer’s current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
  - — visiting the residence, office, factory, or farm (with the RM recording the results

of the visit or conversations in a memorandum);
- — checking the information against the telephone directory; the client's residence, as indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
- — obtaining a reference from the client's government or known employer or from another bank;
- — checking with a credit bureau or professional corroboration organization; or
- — any other method verified by the RM.

- Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer's commercial transactions. This information should include a description of the nature of the customer's business operations or means of generating income, primary trade or business areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
  - — a visit to the office, factory, or farm
  - — a reliable third party who has a business relationship with the customer
  - — financial statements
  - — Dun and Bradstreet reports
  - — newspaper or magazine articles
  - — LexisNexis reports on the customer or customer's business
  - — "Who's Who" reports from the home country
  - — private investigations
- Although it is often not possible to get proof of a client's wealth, the RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
- As part of the ongoing CDD process, the RM should document in memos or "call reports" the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the bank, and updates and strengthens the CDD profile.

As a rule, most private banks make it a policy not to accept walk-in clients. If an exception is made, procedures for the necessary documentation and approvals supporting the exception should be in place. Similarly, other exceptions to policy and procedures should readily identify the specific exception and the required due-diligence and approval process for overriding existing procedures.

In most instances, all CDD information and documentation should be maintained and available for examination and inspection at the location where the account is located or where the financial services are rendered. If the bank maintains centralized customer files in locations other than where the account is located or the financial services are rendered, complete customer information, identification, and documentation must be made available at the location where the account is located or where the financial services are rendered within 48 hours of a Federal Reserve examiner's request. Off-site storage of CDD information will be allowed only if the bank has adopted, as part of its customer-due-diligence program, specific procedures designed to ensure that (1) the accounts are subject to ongoing Office of Foreign Assets Control screening that is equivalent to the screening afforded other accounts, (2) the accounts are subject to the same degree of review for suspicious activity, and (3) the bank demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

CDD procedures should be no different when the institution deals with a financial adviser or other type of intermediary acting on behalf of a client. To perform its CDD responsibilities when dealing with a financial adviser, the institution should identify the beneficial owner of the account (usually the intermediary's client, but in rare cases, it is the intermediary itself) and perform its CDD analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's CDD responsibilities.

The purpose of all private-banking relationships should also be readily identified. Incoming customer funds may be used for various purposes, such as establishing deposit accounts, funding investments, or establishing trusts. The bank's CDD procedures should allow for the collection of sufficient information to develop a transaction or client profile for each customer, which will be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the transaction or client profile for a customer and which may thus constitute suspicious activity.

Suspicious Activity Reports by Depository Institutions. The proper and timely filing of Suspicious Activity Report (SAR) forms is an important component of a bank's CDD program. Since 1996, the federal financial institution supervisory agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) have required banking organizations to report known or suspected violations of law as well as suspicious transactions on a suspicious activity report or SAR form. See the Board's SAR form regulation (Regulation H, section 208.62 (12 CFR 208.62)).[5] Law enforcement agencies use the information reported on the form to initiate investigations, and Federal Reserve staff use the SAR form information in their examination and oversight of supervised institutions.

A member bank is required to file a SAR form with the appropriate federal law enforcement agencies and the Department of the Treasury. A SAR form must be prepared in accordance with the form's instructions and is to be sent to FinCEN when an institution detects—

- insider abuse involving any amount,
- violations aggregating $5,000 or more in which a suspect can be identified,
- violations aggregating $25,000 or more regardless of a potential suspect, or
- transactions aggregating $5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.

When a SAR form is filed, the management of a member bank must promptly notify its board of directors or a committee thereof.

A SAR form must be filed within 30 calendar days after the date of initial detection of the facts that may constitute a basis for filing a SAR form. If no suspect was identified on the date of detection of the incident requiring the filing, a member bank may delay filing a SAR form for an additional 30 calendar days in order to identify the suspect. Reporting may not be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. In situations involving violations requiring immediate attention, such as when a reportable violation is ongoing, the financial institution is required to immediately notify an appropriate law enforcement authority in addition to its timely filing of a SAR form.

A bank's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. Any information suggesting that suspicious activity has occurred should be pursued, and, if an explanation is not forthcoming, the matter should be reported to the bank's management. Examiners should ensure that the bank's approach to SAR forms is proactive and that well-established procedures cover the SAR form process. Accountability should exist within the organization for the analysis and follow-up of internally identified suspicious activity; this analysis should conclude with a decision on the appropriateness of filing a SAR form. See the core procedures concerning suspicious-activity-reporting requirements in the FFIEC *BSA/AML Examination Manual.*

5. The Board's SAR form rules apply to state member banks, bank holding companies and their nonbank subsidiaries, some of which have other independent SAR requirements (for example, broker-dealers), Edge and agreement corporations, and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

Credit-Underwriting Standards

The underwriting standards for private-banking loans to high net worth individuals should be consistent with prudent lending standards. The same credit policies and procedures that are applicable to any other type of lending arrangement should extend to these loans. At a minimum, sound policies and procedures should address the following: all approved credit products and services offered by the institution, lending limits, acceptable forms of collateral, geographic and other limitations, conditions under which credit is granted, repayment terms, maximum tenor, loan authority, collections and charge-offs, and prohibition against capitalization of interest.

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances the bank's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. The bank should perform its due diligence by adequately and reasonably ascertaining and documenting that the funds of its private-banking customers were derived from legitimate means. Banks should also verify that the use of the loan proceeds is for legitimate purposes.

In addition, bank policies should explicitly describe the terms under which "margin loans," loans collateralized by securities, are made and should ensure that they conform to applicable regulations. Management should review and approve daily MIS reports. The risk of market deterioration in the value of the underlying collateral may subject the lender to loss if the collateral must be liquidated to repay the loan. In the event of a "margin call," any shortage should be paid for promptly by the customer from other sources pursuant to the terms of the margin agreement.

In addition, policies should address the acceptance of collateral held at another location, such as an affiliated entity, but pledged to the private-banking function. Under these circumstances, management of the private-banking function should, at a minimum, receive frequent reports detailing the collateral type and current valuation. In addition, management of the private-banking function should be informed of any changes or substitutions in collateral.

Fiduciary Standards

Fiduciary risk is managed through the maintenance of an effective and accountable committee structure; retention of technically proficient staff; and development of effective policies, procedures, and controls. In managing its fiduciary risk, the bank must ensure that it carries out the following fiduciary duties:

- *Duty of loyalty.* Trustees are obligated to make all decisions based exclusively on the best interests of trust customers. Except as permitted by law, trustees cannot place themselves in a position in which their interests might conflict with those of the trust beneficiaries.
- *Avoidance of conflicts of interest.* Conflicts of interest arise in any transaction in which the fiduciary simultaneously represents the interests of multiple parties (including its own interests) that may be adverse to one another. Institutions should have detailed policies and procedures regarding potential conflicts of interest. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may arise throughout an institution. Care should be taken by fiduciary business lines, in particular, to manage conflicts of interest between fiduciary business lines and other business lines (including other fiduciary business lines). Consequently, management throughout the institution should receive training in these matters. For more information on the supervision of fiduciary activities, see section 4200.0 in this manual and section 3120.0 of the *Bank Holding Company Supervision Manual.*
- *Duty to prudently manage discretionary trust and agency assets.* Since 1994, the majority of states have adopted laws concerning the prudent investor rule (PIR) with respect to the investment of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, the standard is traditionally applied to all accounts for which the institution is managing funds.

Operational Controls

To minimize any operational risks associated with private-banking activities, management is responsible for establishing an effective internal control infrastructure and reliable management information systems. Critical operational controls over any private-banking activity include the establishment of written policies and procedures, segregation of duties, and comprehensive management reporting. Throughout this section, specific guidelines and examination procedures for assessing internal controls over different private-banking activities are provided. Listed below are some of those guidelines that cover specific private-banking services.

Segregation of Duties

Banking organizations should have guidelines on the segregation of employees' duties in order to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and CDD documentation. Control-conscious institutions may use independent units, such as compliance, risk management, or senior management to fill this function in lieu of the back office. The audit and compliance functions of the private-banking entity should be similarly independent so that they can operate autonomously from line management.

Inactive and Dormant Accounts

Management should be aware that banking laws in most states prohibit banks from offering services that allow deposit accounts to be inactive for prolonged periods of time (generally, 12 or more months with no externally generated account-balance activity). These regulations are based on the presumption that inactive and dormant accounts may be subject to manipulation and abuse by insiders. Policies and procedures should delineate when inactivity occurs and when inactive accounts should be converted to dormant status. Effective controls over dormant accounts should include a specified time between the last customer-originated activity and its classification as dormant, the segregation of signature cards for dormant accounts, dual control of records, and the blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management.

Pass-Through Accounts and Omnibus Accounts

Pass-through accounts (PTAs) extend checking-account privileges to the customers of a foreign bank; several risks are involved in providing these accounts. In particular, if the U.S. banking entity does not exercise the same due diligence and customer vetting for PTAs as it does for domestic account relationships, the use of PTAs may facilitate unsafe and unsound banking practices or illegal activities, including money laundering. Additionally, if accounts at U.S. banking entities are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss as a result of asset seizures and forfeitures brought by law enforcement authorities. It is recommended that U.S. banking entities terminate a payable-through arrangement with a foreign bank in situations in which (1) adequate information about the ultimate users of PTAs cannot be obtained, (2) the foreign bank cannot be relied on to identify and monitor the transactions of its own customers, or (3) the U.S. banking entity is unable to ensure that its payable-through accounts are not being used for money laundering or other illicit purposes.

Omnibus, or general clearing, accounts may also exist in the private-banking system. They may be used to accommodate client funds before an account opening to expedite a new relationship, or they may fund products such as mutual funds in which client deposit accounts may not be required. However, these accounts could circumvent an audit trail of client transactions. Examiners should carefully review a bank's use of such accounts and the adequacy of its controls on their appropriate use. Generally, client monies should flow through client deposit accounts, which should function as the sole conduit and paper trail for client transactions.

Hold-Mail, No Mail, and E-mail-Only Controls

Controls over hold-mail, no-mail, and e-mail-only accounts are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Hold-mail, no-mail, and e-mail-only account operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

Funds Transfer—Tracking Transaction Flows

One way that institutions can improve their customer knowledge is by tracking the transaction flows into and out of customer accounts and payable-through subaccounts. Tracking should include funds-transfer activities. Policies and procedures to detect unusual or suspicious activities should identify the types of activities that would prompt staff to investigate the customer's activities and should provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide bank personnel in identifying some potential abuses:

- indications of frequent overrides of established approval authority or other internal controls
- intentional circumvention of approval authority by splitting transactions
- wire transfers to and from known secrecy jurisdictions
- frequent or large wire transfers for persons who have no account relationship with the bank, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account
- wire transfers involving cash amounts in excess of $10,000
- inadequate control of password access
- customer complaints or frequent error conditions

Custody—Detection of Free Riding

Custody departments should monitor account activity to detect instances of *free-riding,* the practice of offering the purchase of securities without sufficient capital and then using the proceeds of the sale of the same securities to cover the initial purchase. Free-riding poses significant risk to the institution and typically occurs without the bank's prior knowledge. Free-riding also violates margin rules (Regulations T, U, and X) governing the extension of credit in connection with securities transactions. (See SR-93-13.)

Management Information Systems

Management information systems (MIS) should accumulate, interpret, and communicate information on (1) the private-banking assets under management, (2) profitability, (3) business and transaction activities, and (4) inherent risks. The form and content of MIS for private-banking activities will be a function of the size and complexity of the private-banking organization. Accurate, informative, and timely reports that perform the following functions may be prepared and reviewed by RMs and senior management:

- aggregate the assets under management according to customer, product or service, geographic area, and business unit
- attribute revenue according to customer and product type
- identify customer accounts that are related to or affiliated with one another through common ownership or common control
- identify and aggregate customer accounts by source of referral
- identify beneficial ownership of trust, PIC, and similar accounts

To monitor and report transaction activity and to detect suspicious transactions, management reports may be developed to—

- monitor a specific transaction criterion, such as a minimum dollar amount or volume or activity level;
- monitor a certain type of transaction, such as one with a particular pattern;
- monitor individual customer accounts for variations from established transaction and activity profiles based on what is usual or expected for that customer; and
- monitor specific transactions for BSA compliance.

In addition, reports prepared for private-banking customers should be accurate, timely, and informative. Regular reports and statements prepared for private-banking customers should adequately and accurately describe the application of their funds and should detail all transactions and activity that pertain to the customers' accounts.

Furthermore, MIS and technology play a role in building new and more direct channels of information between the institution and its private-banking customers. Active and sophisticated customers are increasing their demand for data relevant to their investment needs, which is fostering the creation of online information services. Online information can satisfy customers' desire for convenience, real-time access to information, and a seamless delivery of information.

Audit

An effective audit function is vital to ensuring the strength of a private bank's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities of the organization. Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client CDD procedures. Compliance with CDD policies and procedures and the detailed testing of files for CDD documentation are also key elements of the audit function. Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

Compliance

The responsibility for ensuring effective compliance with relevant laws and regulations may vary among different forms of institutions, depending on their size, complexity, and availability of resources. Some institutions may have a distinct compliance department with the centralized role of ensuring compliance institution-wide, including private-banking activities. This arrangement is strongly preferable to a situation in which an institution delegates compliance to specific functions, which may result in the management of private-banking operations being responsible for its own internal review. Compliance has a critical role in monitoring private-banking activities; the function should be independent of line management. In addition to ensuring compliance with various laws and regulations such as the Bank Secrecy Act and those promulgated by the Office of Foreign Assets Control, compliance may perform its own internal investigations and due diligence on employees, customers, and third parties with whom the bank has contracted in a consulting or referral capacity and whose behavior, activities, and transactions appear to be unusual or suspicious. Institutions may also find it beneficial for compliance to review and authorize account-opening documentation and CDD adequacy for new accounts. The role of compliance is a control function, but it should not be a substitute for regular and frequent internal audit coverage of the private-banking function. Following is a description of certain regulations that may be monitored by the compliance function.

Office of Foreign Assets Control

The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals. Sanctions are imposed against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC acts under presidential wartime and national emergency powers, as well as under authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under U.S. jurisdiction. Many of the sanctions are based on United Nations and other international mandates, are multilateral in scope, and involve close cooperation with allied governments. Under the International Emergency Economic Powers Act, the President can impose sanctions, such as trade embargoes, the freezing of assets, and import surcharges, on certain foreign countries and the "specially designated nationals" of those countries.

A "specially designated national" is a person or entity who acts on behalf of one of the countries under economic sanction by the United States. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the United States are frozen. In certain cases, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his or her account. The license can be either general or specific.

OFAC screening may be difficult when transactions are conducted through PICs, token names, numbered accounts, or other vehicles that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC specially designated nationals and blocked foreign countries as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Any violation of regulations implementing designated national sanctions subjects the violator to criminal prosecution, including prison sentences and fines to corporations and individuals, per incident. Any funds frozen because of OFAC orders should be placed in a blocked account. Release of those funds cannot occur without a license from the Treasury Department.

Bank Secrecy Act

Guidelines for compliance with the Bank Secrecy Act (BSA) can be found in the FFIEC *BSA/AML Examination Manual.* See also the question-and-answer format interpretations (SR-05-9) of the U.S. Department of Treasury's regulation (31 CFR 1010) for banking organizations, which is based on section 326 of the Patriot Act. In addition, the procedures for conducting BSA examinations of foreign offices of U.S. banks are detailed in the FFIEC *BSA/AML Examination Manual*. The SAR form filing requirements for nonbank subsidiaries of bank holding companies and state member banks are also set forth in SR-10-8.

PREPARATION FOR EXAMINATION

The following subsections provide examiners with guidance on preparing for the on-site examination of private-banking operations, including determination of the examination scope and drafting of the first-day-letter questionnaire that is provided to the institution.

Preexamination Review

To prepare the examiners for their assignments and to determine the appropriate staffing and scope of the examination, the following guidelines should be followed during the preexamination planning process:

- Review the prior report of examination and workpapers for the exam scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide insight to key contacts at the institution and to the time frame of the prior private-banking review.
- Obtain relevant correspondence sent since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory action.
- Research press releases and published news stories about the institution and its private-banking activities.
- Review internal and external audit reports and any internal risk assessments performed by the institution on its private-banking activities. Such reports should include an assessment of the internal controls and risk profile of the private-banking function.
- Contact the institution's management to ascertain what changes have occurred since the last exam or are planned in the near future. For example, examiners should determine if there have been changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered. If there is no mention of private banking in the prior examination report, management should be asked at this time if they have commenced or plan to commence any private-banking activities.
- Follow the core examination procedures in the FFIEC *BSA/AML Examination Manual* in order to establish the base scope for the examination of private-banking activities. Review and follow the expanded procedures for private banking and any other expanded procedures that are deemed necessary.

Examination Staffing and Scope

Once the exam scope has been established and before beginning the new examination, the examiner-in-charge and key administrators of the examination team should meet to discuss the private-banking examination scope, the assignments of the functional areas of private banking, and the supplemental reviews of specific private-banking products and services. If the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization, examiners may be forced to go beyond a rudimentary review of private-banking operations. They will probably need to focus on the policies, practices, and risks within the different divisions of a particular institution and throughout the institution's global network of affiliated entities.

Reflection of Organizational Structure

The review of private-banking activities should be conducted on the basis of the financial institution's organizational structure. These structures may vary considerably, depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution conducts in the United States and abroad. This broad view is needed to maintain the "big picture" impact of private banking for a particular institution.

Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the risk-focused examination approach. The exam scope and degree of testing of private-banking practices should reflect the degree of risk assumed, prior exam findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution's internal audit and other assessment practices raise doubts about the internal system's effectiveness, expanded analysis and review are required. Examiners should then perform more transaction testing. Examiners will usually need to follow the core examination procedures in the FFIEC *BSA/AML Examination Manual* as well as the expanded procedures for private banking. Other expanded procedures should be followed if circumstances dictate.

First-Day Letter

As part of the examination preparation, examiners should customize the first-day-letter questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the exam. The following is a list of requests regarding private banking that examiners should consider including in the first-day letter. Responses to these items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries:

- organizational chart for the private bank on both a functional and legal-entity basis
- business or strategic plan
- income and expense statements for the prior fiscal year and current year to date, with projections for the remainder of the current and the next fiscal year, and income by product division and marketing region
- balance-sheet and total assets under management (list the most active and profitable accounts by type, customer domicile, and responsible account officer)
- most recent audits for private-banking activities
- copies of audit committee minutes
- copy of the CDD and SAR form policies and procedures
- list of all new business initiatives introduced last year and this year, relevant new-product-approval documentation that addresses the evaluation of the unique characteristics and risk associated with the new activity or product, and an assessment of the risk-management oversight and control infrastructures in place to manage the risks
- list of all accounts in which an intermediary is acting on behalf of clients of the private bank, for example, as financial advisers or money managers
- explanation of the methodology for following up on outstanding account documentation and a sample report
- description of the method for aggregating client holdings and activities across business units throughout the organization
- explanation of how related accounts, such as common control and family link, are identified
- name of a contact person for information on compensation, training, and recruiting programs for relationship managers
- list of all personal investment company accounts
- list of reports that senior management receives regularly on private-banking activities
- description and sample of the management information reports that monitor account activity
- description of how senior management monitors compliance with global policies for world-

wide operations, particularly for offices operating in secrecy jurisdictions
- appropriate additional items from the core and expanded procedures for private banking, as set forth in the FFIEC *BSA/AML Examination Manual,* as well as any other items from the expanded procedures that are needed to gauge the adequacy of the BSA/AML program for private-banking activities.

1. To determine if the policies, practices, procedures, and internal controls regarding private-banking activities are adequate for the risks involved.
2. To determine if the bank's officers and employees are operating in conformance with established guidelines for conducting private-banking activities.
3. To assess the financial condition and income-generation results of the private-banking activities.
4. To determine the scope and adequacy of the audit function for private-banking activities.
5. To determine compliance with applicable laws and regulations for private banking.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are found.

As appropriate, the examiner-in-charge should supplement the following procedures with the examination procedures for private banking set forth in the FFIEC's *BSA/AML Examination Manual.* See that manual's core examination procedures for the BSA/AML compliance program and the expanded examination procedures for private banking.

PRIVATE-BANKING PREEXAMINATION PROCEDURES

1. As the examiner-in-charge, conduct a meeting with the lead members of the private-banking examination team and discuss—
   a. the private-banking examination scope (The examination may need to extend beyond a rudimentary review of private-banking operations if the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization. Examiners will probably need to focus on the policies, practices, and risks within the different divisions of the bank and, if applicable, throughout the bank's domestic or foreign-affiliated entities.);
   b. examiner assignments for the functional areas of private banking; and
   c. the supplemental reviews of specific private-banking products and services.
2. Review the prior report of examination and the previous examination's workpapers; description of the examination scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior examination. The prior examination report and examination plan should also provide information and insight on key contacts at the bank and on the time frame of the prior private-banking review.
3. Review relevant correspondence exchanged since the prior examination, such as management's response to the report of examination, any applications submitted to the Federal Reserve, and any supervisory actions.
4. Research press releases and published news stories about the bank and its private-banking activities.
5. Review internal and external audit reports and any internal risk assessments performed by the bank's internal or external auditors on its private-banking activities. Review information on any assessments of the internal controls and risk profile of the private-banking function.
6. Contact management at the bank to ascertain what changes in private-banking services have occurred since the last examination or if there are any planned in the near future.
   a. Determine if the previous examination or examination report(s) mention private banking; if not, ask management if they have commenced or plan to commence any private-banking activities within any part of the bank's organization.
   b. Determine if there have been any changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered.
   c. During the entire examination of private-banking activities, be alert to the totality of the client relationship, product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

FULL-EXAMINATION PHASE

1. After reviewing the private-banking functional areas, draw sound conclusions about the quality and culture of management and stated private-banking policies.
2. Evaluate the adequacy of risk-management policies and practices governing private-banking activities.
3. Assess the organization of the private-banking function and evaluate the quality of management's supervision of private-banking activities. An appraisal of management covers the—
   a. full range of functions (i.e., supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance) and activities related to

the operation of the private-banking activities and

b. discharge of responsibilities by the bank's directors through a long-range organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the bank's private-banking business.

4. Determine if management has effective procedures for conducting ongoing reviews of client-account activity to detect, and protect the client from, any unauthorized activity and any account activity that is inconsistent with the client's profile (for example, frequent or sizable unexplained transfers flowing through the account).
5. Determine if the bank has initiated private-banking account-opening procedures and documentation requirements that must be satisfied before an account can be opened. Determine if the bank maintains internal controls over these procedures and requirements.
6. Determine if the bank requires its subsidiary entities and affiliates to maintain and adhere to well-structured customer-due-diligence (CCD) procedures.
7. Determine if the bank has proper controls and procedures to ensure its proper administration of trust and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. Review previous trust examination reports and consult with the designated Federal Reserve System trust examiners.
8. Ascertain whether the bank adequately supervises its custody services. The bank should ensure that it, and its nonbank entities, have established and currently maintain procedures for the proper administration of custody services, including the regular review of the services on a preset schedule.
9. Determine whether the bank's nonbank subsidiaries and affiliates are required to, and actually maintain, strong controls and supervision over funds transfers.
10. Ascertain if the bank's management and staff are required to perform due diligence, that is, to verify and document that the funds of its private-banking customers were derived through legitimate means, and when extending credit, to verify that the use of loan proceeds was legitimate.
11. Review the bank's use of deposit accounts.
    a. Assess the adequacy of the bank's controls and whether they are appropriately used.
    b. Determine if client monies flow through client deposit accounts and whether the accounts function as the sole conduit and paper trail for client transactions.
12. Determine and ensure that the bank's approach to Suspicious Activity Reports is proactive and that it has well-established procedures covering the SAR process. Establish whether there is accountability within the organization for the analysis and follow-up of internally identified suspicious activity (this analysis includes a sound decision on whether the bank needs to file, or is required by regulation to file, a SAR).

Employee benefit trusts are specialized trusts most commonly established to provide retirement benefits to employees. However, they may also be established for employee stock ownership or thrift purposes, or to provide medical, accident, and disability benefits. There are qualified and unqualified plans. Retirement plans are qualified under section 401 of the Internal Revenue Code (IRC), and employee benefit trusts are tax exempt under section 501(a) of the IRC. The major types of qualified plans are profit sharing, money purchase, stock bonus, employee stock ownership plans (ESOPS), 401(k) plans, and defined benefit pension plans.

Since 1974, state jurisdiction of employee benefit trusts and their administration has been largely preempted by a comprehensive scheme of federal laws and regulations under the Employee Retirement Income Security Act of 1974 (ERISA). ERISA is divided into four titles: Title I, ''Protection of Employee Benefit Rights,'' includes the fiduciary responsibility provisions (in part 4) that are interpreted and enforced by the U.S. Department of Labor (DOL). Title II, ''Amendments to the Internal Revenue Code Relating to Retirement Plans,'' is similar to Title I, but the Internal Revenue Service (IRS) is responsible for its enforcement. Title III, ''Jurisdiction, Administration, Enforcement,'' grants jurisdiction and powers for administration to various governmental units. Title IV, ''Plan Termination Insurance,'' establishes the Pension Benefit Guaranty Corporation (PBGC). The PBGC ensures that defined benefit plans have sufficient resources to provide minimum levels of benefits to participants. In addition to the PBGC, the primary agencies that have promulgated necessary regulations and interpretations pursuant to ERISA are the DOL and IRS. However, state and federal banking agencies also have a recognized role under this statute.

Numerous laws affecting employee benefit plans have been enacted since the adoption of ERISA; however, the most sweeping changes were imposed by the Tax Reform Act of 1986. These changes include (1) imposing numerous excise taxes on employers and employees for failure to meet new plan contribution and distribution rules, (2) lowering the maximum amount of contributions and benefits allowed under qualified defined contribution and defined benefit plans, (3) lowering the amount an individual can contribute to a 401(k) plan, and (4) providing new nondiscrimination rules covering plan contributions and distributions. Virtually all qualified plans had to be amended to comply with this law.

A specific statutory provision of ERISA mandates the exchange of information among federal agencies. Accordingly, the federal banking agencies have entered into an agreement with the DOL whereby a banking agency noting any possible ERISA violations that meet certain specific criteria will refer the matter to the DOL.

ERISA imposes very complex requirements on banks acting as trustees or in other fiduciary capacities for employee benefit trusts. Severe penalties can result from violations of statutory obligations. With respect to a bank's own employees' retirement plan, the bank (or ''plan sponsor''), regardless of whether it is named trustee, is still a ''party-in-interest'' pursuant to the statute. Therefore, unless a transaction qualifies for narrowly defined statutory exemptions (or unless it is the subject of a specific ''individual'' exemption granted by the DOL), any transaction involving the purchase or sale of an asset of the plan from or to the bank, any affiliate, officer, or employee could constitute a prohibited transaction under ERISA.

The current and projected costs of employee benefit plans should be analyzed for their impact on the expenses and overall financial condition of the bank. Excessive pension or profit-sharing benefits, large expense accounts, employment contracts, or bonuses for officers or directors (especially if they are also large shareholders) could prove detrimental and even lead to civil liability for the bank or its board.

Depending on the type of plan and the allocations of its fiduciary duties, certain reporting, disclosure, and plan design requirements are imposed on the plan sponsor and/or its designated supervising committee. Therefore, a bank should have appropriate expertise, policies, and procedures to properly administer the type of employee benefit accounts established for its employees.

If an examiner, as part of any examination assignment, detects possible prohibited transactions, self-dealing, or other questionable activities involving the bank's employee benefit plan, an appropriate investigation should be undertaken. Substantial conversions of existing defined benefit plans or plan assets into holdings of bank or affiliate stock, under certain circumstances, could involve ERISA violations. An examiner should refer a complicated question arising out of any of these situations to the examiner-in-charge for resolution or submission to the Reserve Bank.

Part I of the following examination procedures (section 4080.3) should be completed for every commercial bank examination; part II should also be completed if the employee benefit plan is not trusteed by the bank or by an affiliate bank subject to supervision by a federal banking agency. Parts I and II may be completed by a trust specialist, if available. When a bank trust department is named as trustee, the examiner should determine whether compliance with ERISA was reviewed during the previous trust examination. If not, then part II should be completed.

1. To determine if the policies, practices, procedures, internal controls, and available expertise regarding employee benefit trusts are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the impact of employee benefit plans and related benefits on the financial condition of the bank.
4. To determine compliance with laws, regulations, and instrument provisions.
5. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations, or the governing instruments have been noted.

PART I

1. If selected for implementation, complete or update the Employee Benefit Trusts section of the Internal Controls Questionnaire.
2. Test for compliance with policies, practices, procedures and internal controls in conjunction with performing the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if appropriate corrections have been made.
3. Determine the approximate number, size and types of employee benefit plans held for the benefit of the bank's officers and employees.
4. Obtain plan instruments or amendments thereto (if any) and summarize key features for the work papers. As appropriate, add or update the following information:
   a. Date of adoption of new plan or amendment and brief summary of the plan or amendment.
   b. Parties or committees named trustee and (if different) person(s) responsible for making investment decisions.
   c. Individuals, committees or outside parties named as responsible for plan administration.
   d. Basic investment/funding characteristics (e.g., "non-contributory profit-sharing, up to 100% in own BHC stock;" "contributory defined benefit pension plan, purchasing diversified securities," etc.).
   e. Latest Form 5500 (IRS) filed for plan (may be omitted if plan administrator is an affiliate bank or bank holding company).

   Example: First Bank established a non-contributory profit sharing trust in 1975 for all officers and employees. Latest amendment, as of December 31, 19XX, made technical alterations to the vesting and forfeiture provisions. The most recent available valuation of the trust's assets, dated June 30, 19XX, indicated total assets of $22,093,000 (market value). Assets were comprised of U.S. government securities (42%), listed stocks (53%) and cash equivalents. Bank of ___________, as trustee, has sole investment responsibility.

5. If a plan is a defined benefit pension plan, ascertain the actuarily-determined amount of unfunded pension liability, if any, and the bank's arrangements for amortization. (Note: Unfunded pension liability represents a contingent liability per instructions for the Report of Condition.)

6. Determine if the current and projected costs of the employee benefit plan(s) is reasonable in light of the bank's financial condition.

Complete part II of these procedures, if applicable, then continue to step 7, below. Part II is to be completed when a plan for the bank's employees is administered by the bank or a bank committee and is not trusteed by the bank itself or an affiliate bank subject to supervision by a federal banking agency.

7. Determine whether any instances of possible violations of ERISA have been noted, and that as to each such instance, full information has been developed for current workpapers to support a referral to DOL pursuant to SR-81-697/TR-81-46.

   Note: While the final decision on whether or not to make a referral to the DOL is to be made by the Board's staff after receipt of the report of examination, complete information should always be obtained regarding possible ERISA violations in the event the decision is made to refer the matter. If gathering certain of the information would impose an undue burden upon the resources of the examiners or the bank, Board's staff (Trust Activities Program) should be consulted. Where a significant prohibited transaction such as self dealing has taken place, the bank should be clearly informed that it is expected to undertake all such corrective and/or remedial actions as are necessary under the circumstances. One measure would be for the bank to apply to the DOL for a retroactive exemption under ERISA section 408(a).

8. Reach a conclusion concerning:
   a. The adequacy of policies, practices and procedures relating to employee benefit trusts.
   b. The manner in which bank officers are operating in conformance with established policy.
   c. The accuracy and completeness of any schedules obtained.
   d. Internal control deficiencies or exceptions.
   e. The quality of departmental management.
   f. Other matters of significance.
9. Prepare in appropriate report format, and discuss with appropriate officer(s):
   a. Violations of laws and regulations.
   b. Recommended corrective action when policies, practices or procedures are deficient.
10. Update the workpapers with any information that will facilitate future examinations.

PART II

1. Review plan asset listings, valuations, or printouts obtained for any instances of possible prohibited transactions (ERISA sections 406(a) and (b)). The listings should include holdings of:
   a. Loans.
   b. Leases.
   c. Real Estate.
   d. Employer stock or other securities or obligations.
   e. Own bank time deposits.
   f. Other assets which might constitute, or result from, prohibited transactions.
2. Review transaction(s)/holding(s) in the previous step for conformity to:
   a. ERISA provisions regarding employer securities or real estate (sections 407(a), (b) and (c)) and related regulations.
   b. Statutory exemptions of ERISA (section 408(b)).
   c. “Exclusive benefit,” prudence and diversification requirements of ERISA (sections 404(a) and (b)).

Review the bank's internal controls, policies, practices and procedures for employee benefit accounts. 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. Part I should be completed as part of every examination; both parts I and II should be completed whenever the plan, administered by the bank or a bank committee, is *not* trusteed by the bank itself or by an affiliate bank subject to supervision by a federal banking agency.

PART I

1. Are new employee benefit plans, significant amendments thereto, and related costs and features approved by the bank's board of directors?

*2. Does the institution obtain and maintain on file the following minimum documentation:

   a. The plan and the corporate resolution adopting it?

   b. IRS "determination" or "opinion" letter substantiating the tax-exempt status of the plan?

   c. The trust agreement and the corporate resolution appointing the trustee(s), if applicable? (On occasion, fully insured plans may have no named trustee.)

   d. Amendments to the plan or trust documents?

3. If the bank or a committee of its officers and employees acts as plan administrator for any plan(s), does it have internal procedures and/or has it arranged by contract for external administrative expertise sufficient to assure compliance with reporting, disclosure and other administrative requirements of ERISA and related regulations?

4. Have the bank, its officers, directors or employees, or any affiliate(s) entered into any transactions to buy or sell assets to the bank's employee benefit plan(s)?

5. Do plan investments conform to instrument investment provisions?

PART II

1. When exercising fiduciary responsibility in the purchase or retention of employer securities or employer real estate, does the bank have procedures to assure conformity with ERISA section 407 and related provisions?

   Note: The requirements of ERISA and the associated DOL regulation with respect to "employer securities and employer real estate" include:

   a. A plan may not acquire or hold any but "qualifying employer securities and employer real estate."

   b. A defined benefit plan may hold no more than 10 percent of the fair market value of its assets in qualifying employer securities and/or qualifying employer real property, except as provided by ERISA sections 407(a)(3) or 414(c)(1) and (2), and adopted regulations.

   c. Any dispositions of such property from a plan to a party-in-interest shall conform to ERISA sections 414(c)(3) and (5) and adopted regulations, but certain acquisitions and sales may be made pursuant to the section 408(a) exemption.

   d. The plan instrument, for an eligible individual account plan which is to hold in excess of 10 percent of the fair market value of its assets in qualifying employer securities or real property, shall provide explicitly the extent to which such plan may hold such assets. [ERISA sections 407(b)(1) and (d)(3)]

2. Does the bank have procedures to ensure conformance to the following statutory exemptions (and associated regulations) from the prohibited transactions provisions of ERISA:

   a. Loans made by the plan to parties-in-interest who are participants or beneficiaries? [ERISA section 408(b)(1)]

   b. Investment in deposits which bear a reasonable rate of interest of a bank which is a fiduciary of the plan? [ERISA section 408(b)(4)]

   Note: Other statutory exemptions which may on occasion be applicable are:

c. Arrangements for office space or legal, accounting or other necessary services? [ERISA section 408(b)(2)]
d. Loans to employee stock ownership trusts? [ERISA section 408(b)(3)]
e. Transactions between a plan and a collective trust fund maintained by a party-in-interest which is a bank or trust company? [section 408(b)(8)]
f. Providing of any ancillary service by a bank or trust company which is a fiduciary of the plan? [ERISA section 408(b)(6)]

3. If exercising or sharing fiduciary responsibility, does the bank have procedures designed:

   a. To ensure that duties are executed for the exclusive benefit of plan participants and beneficiaries, in accordance with the "prudent man" standard? [ERISA sections 404(a)(1)(A) and (B)]

   b. To ensure that investments are diversified, unless it is clearly prudent not to do so or otherwise excepted by other provisions of ERISA? [ERISA section 404(a)(1)(C)]

A bank operates as a securities dealer when it underwrites, trades, or deals in securities. These activities may be administered in a separately identifiable trading department or incorporated within the overall treasury department. The organizational structure will generally be a function of the level of activity and the importance of the activity as a product line. If a repetitive pattern of short-term purchases and sales demonstrates that the bank holds itself out to other dealers or investors as a securities dealer, the bank is trading, regardless of what department or section of the bank is engaged in the activity.

The authority under which a bank may engage in securities trading and underwriting is found in section 5136 of the Revised Statutes (12 USC 24 (seventh)). That authority is restricted by limitations on the percentage holding of classes of securities as found in 12 CFR 1.3. This regulation allows banks to deal, underwrite, purchase, and sell (1) type I securities without limit and (2) type II securities subject to a limit of 10 percent of capital and unimpaired surplus per issue. Banks are prohibited from underwriting or dealing in type III securities for their own accounts. See section 2020.1, "Investment Securities and End-User Activities," for further information on types I, II, and III securities.

Banks are involved in three major types of securities transactions. First, the bank, acting as broker, buys and sells securities on behalf of a customer. These are agency transactions in which the agent (bank) assumes no substantial risk and is compensated by a prearranged commission or fee. A second type of securities transaction banks frequently execute is a "riskless-principal" trade. Upon the order of an investor, the dealer buys (or sells) securities through its own account, with the purchase and sale originating almost simultaneously. Because of the brief amount of time the security is held in the dealer's own account, exposure to market risks is limited. Profits result from dealer-initiated markup (the difference between the purchase and sale prices). Finally, as a dealer, the bank buys and sells securities for its own account. This is termed a principal transaction because the bank is acting as a principal, buying or selling qualified securities through its own inventory and absorbing whatever market gain or loss is made on the transaction.

The volume of bank dealer activity and the dealer's capacity in the transaction are critical to an examiner's assessment regarding the examination scope and the required examiner resources and expertise. Dealers engaging primarily in agency or riskless-principal transactions are merely accommodating customers' investment needs. Market risk will be nominal, and the key examination concern will be operational risk and efficiency. Active dealers generally carry larger inventory positions and may engage in some degree of proprietary trading. Their market-risk profile may be moderate to high.

Bank dealers' securities transactions involve customers and other securities dealers. The word "customer," as used in this section, means an investor. Correspondent banks purchasing securities for an investment account would also be considered a customer. Transactions with other dealers are not considered customer transactions unless the dealer is buying or selling for investment purposes.

The following subsections include general descriptions of significant areas of bank trading and underwriting activities. Foreign exchange is covered in detail in the "International" sections of this manual. Additional bank dealer activities, particularly in derivative products, are extensively covered in the *Trading and Capital-Markets Activities Manual*. In addition, many money-center banks and larger regional banks have transferred dealing activities to separately capitalized holding company subsidiaries (known as underwriting affiliates). The *Bank Holding Company Supervision Manual* contains a separate section on nonbank subsidiaries engaged in underwriting and dealing in bank-ineligible securities.

OVERVIEW OF RISK

For bank dealer activities, risk is generally defined as the potential for loss on an instrument or portfolio. Significant risk can also arise from operational weakness and inadequate controls. Risk management is the process by which managers identify, assess, and control all risks associated with a financial institution's activities. The increasing complexity of the financial industry and the range of financial instruments banks use have made risk management more difficult to accomplish and evaluate.

The four fundamental elements for evaluating the risk-management process for bank dealer activities are—

- active board and management oversight,
- adequate risk-management policies and limits,
- appropriate risk measurement and management information systems, and
- comprehensive internal controls and audit procedures.

For risk management to be effective, an institution's board and senior management must be active participants in the process. They must ensure that adequate policies and risk-tolerance limits are developed for managing the risk in bank dealer activities, and they must understand, review, and approve these limits across all established product lines. For policies and limits to be effective and meaningful, risk measures, reports, and management information systems must provide management and the board with the information and analysis necessary to make timely and appropriate responses to changing conditions. Risk management must also be supported by comprehensive internal controls and audit procedures that provide appropriate checks and balances to maintain an ongoing process of identifying any emerging weaknesses in an institution's management of risk.[1] At a minimum, the effectiveness of the institution's policies, limits, reporting systems, and internal controls must be reviewed annually.

In assessing the adequacy of the above elements at individual institutions, examiners should consider the nature and volume of a bank's dealer activities and its overall approach toward managing the various types of risks involved. The sophistication or complexity of policies and procedures used to manage risk depends on the bank dealer's chosen products, activities, and lines of business. Accordingly, examiners should expect risk-management activities to differ among institutions.

As a financial institution's product offerings and geographic scope expand, examiners must review the risk-management process not only by business line, but on a global, consolidated basis. In more sophisticated institutions, the role of risk management is to identify the risks associated with particular business activities and to aggregate summary data into generic components, ultimately allowing exposures to be evaluated on a common basis. This methodology enables institutions to manage risks by portfolio and to consider exposures in relationship to the institution's global strategy and risk tolerance.

A review of the global organization may reveal risk concentrations that are not readily identifiable from a limited, stand-alone evaluation of a branch, agency, Edge Act institution, nonbank subsidiary, or head office. Consolidated risk management also allows the institution to identify, measure, and control its risks, while giving necessary consideration to the breakdown of exposure by legal entity. Sometimes, if applicable rules and laws allow, identified risks at a branch or subsidiary may be offset by exposures at another related institution. However, risk management across separate entities must be done in a way that is consistent with the authorities granted to each entity. Some financial institutions and their subsidiaries may not be permitted to hold, trade, deal, or underwrite certain types of financial instruments unless they have received special regulatory approval. Examiners should ensure that a financial institution only engages in those activities for which it has received regulatory approval. Furthermore, examiners should verify that the activities are conducted in accordance with any Board conditions or commitments attached to the regulatory approval.

Ideally, an institution should be able to identify its relevant generic risks and should have measurement systems in place to quantify and control these risks. While it is recognized that not all institutions have an integrated risk-management system that aggregates all business activities, the ideal management tool would incorporate a common measurement denominator. Risk-management methodologies in the marketplace and an institution's scope of business are continually evolving, making risk management a dynamic process. Nonetheless, an institution's risk-management system should always be able to identify, aggregate, and control all risks posed by underwriting, trading, or dealing in securities that could have a significant impact on capital or equity.

Trading and market-risk limits should be customized to address the nature of the products

1. Existing policies and examiner guidance on various topics applicable to the evaluation of risk-management systems can be found in SR-93-69, "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations." Many of the managerial and examiner practices contained in this document are fundamental and are generally accepted as sound practices for trading activities.

and any unique risk characteristics. Common types of limits include earnings-at-risk limits, stop-loss limits, limits on notional amounts (both gross and duration-weighted), maturity limits, and maturity-gap limits. The level of sophistication needed within the limit matrix will depend on the type of instrument involved and the relative level of trading activity. Straightforward notional and tenor limits may be adequate for most dealers; however, dealers involved in a wide array of products and more complex transactions will need stronger tools to measure and aggregate risk across products.

In general, risk from trading and dealing activities can be broken down into the following categories:

- Market or price risk is the exposure of an institution's financial condition to adverse movements in the market rates or prices of its holdings before such holdings can be liquidated or expeditiously offset. It is measured by assessing the effect of changing rates or prices on either the earnings or economic value of an individual instrument, a portfolio, or the entire institution.
- Funding-liquidity risk refers to the ability to meet investment and funding requirements arising from cash-flow mismatches.
- Market-liquidity risk refers to the risk of being unable to close out open positions quickly enough and in sufficient quantities at a reasonable price.
- Credit risk is the risk that a counterparty to a transaction will fail to perform according to the terms and conditions of the contract, thus causing the security to suffer a loss in cashflow or market value. Because securities settlements are typically "delivery vs. payment" and settlement periods are relatively short, securities transactions do not involve a significant level of counterparty credit risk. Repurchase transactions, securities lending, and money market transactions, however, involve significantly higher levels of credit risk if not properly controlled. As a result, credit risk is discussed in greater detail in the subsections addressing these products. Credit risk can also arise from positions held in trading inventory. Although U.S. government and agency securities do not generally involve credit risk, other securities (for example, municipal and corporate securities) carried in inventory can decline in price due to a deterioration in credit quality.
- Clearing or settlement risk is (1) the risk that a counterparty who has received a payment or delivery of assets defaults before delivery of the asset or payment or (2) the risk that technical difficulties interrupt delivery or settlement despite the counterparty's ability or willingness to perform.
- Operations and systems risk is the risk of human error or fraud, or the risk that systems will fail to adequately record, monitor, and account for transactions or positions.
- Legal risk is the risk that a transaction cannot be consummated as a result of some legal barrier, such as inadequate documentation, a regulatory prohibition on a specific counterparty, non-enforceability of bilateral and multilateral close-out netting, or collateral arrangements in bankruptcy.

The *Trading and Capital-Markets Activities Manual* contains a comprehensive discussion of these risks, including examination objectives, procedures, and internal control questionnaires by risk category.

GOVERNMENT AND AGENCY SECURITIES

The government securities market is dominated by a number of investment banks, broker-dealers, and commercial banks known as primary dealers in government securities. These dealers make an over-the-counter market in most government and federal-agency securities. Primary dealers are authorized to deal directly with the Open Market Desk of the Federal Reserve Bank of New York. As market makers, primary dealers quote bid-ask prices on a wide range of instruments, and many publish daily quotation sheets or provide live electronic data feeds to larger customers or other dealers.

Government securities trading inventories are generally held with the objective of making short-term gains through market appreciation and dealer-initiated markups. Common factors that affect the markup differential include the size of a transaction, the dealer efforts extended, the type of customer (active or inactive), and the nature of the security. Markups on government securities generally range between $\frac{1}{32}$ and $\frac{4}{32}$ of a point. Long-maturity issues or derivative products may have higher markups due to the higher risk and potentially larger volatility that may be inherent in these products.

According to industry standards, payments for and deliveries of U.S. government and most agency securities are settled one business day following the trade date, although government dealers and customers can negotiate same-day or delayed settlement for special situations.

When-Issued Trading

A significant potential source of risk to dealers involves “when-issued” (WI) trading in government securities. WI trading is the buying and selling of securities in the one- to two-week interim between the announcement of an offering and the security auction and settlement. Although the vast majority of transactions settle on the next business day, WI trading results in a prolonged settlement period. This could increase both the market risk and counterparty credit risk associated with trading these instruments. The prolonged settlement period also provides an opportunity for a dealer to engage in a large volume of off-balance-sheet trading without having to fund the assets or cover the short positions. In essence, WI trading allows the dealers to create securities. If the overall level of WI trading is significant in relation to the size of the issue, the resulting squeeze on the market could increase volatility and risk. Given these potential risk characteristics, WI trading should be subject to separate sublimits to cap the potential exposure.

Short Sales

Another area of U.S. government securities activity involves short-sale transactions. A short sale is the sale of a security that the seller does not own at the time of the sale. Delivery may be accomplished by buying the security or by borrowing the security. When the security delivered is borrowed, the short seller likely will ultimately have to acquire the security in order to satisfy its repayment obligation. The borrowing transaction is collateralized by a security (or securities) of similar value or cash (most likely the proceeds of the short sale). Reverse repurchase transactions are also used to obtain the security needed to make delivery on the security sold short. Carrying charges on borrowed government securities should be deducted from the short sale and purchase spread to determine net profit. Short sales are conducted to (1) accommodate customer orders, (2) obtain funds by leveraging existing assets, (3) hedge the market risk of other assets, or (4) allow a dealer to profit from a possible future decline in market price by purchasing an equivalent security at a later date at a lower price.

Government Securities Clearing

Securities-clearing services for the bulk of U.S. government securities transactions and many federal-agency securities transactions are provided by the Federal Reserve as part of its electronic securities-transfer system. The various Federal Reserve Banks will wire-transfer most government securities between the book-entry safekeeping accounts of the seller and buyer. The Federal Reserve’s systems are also used to facilitate security borrowings, loans, and pledges.

Government Securities Act

In response to the failures of a number of unregulated government securities dealers between 1975 and 1985, Congress passed the Government Securities Act of 1986 (GSA). GSA established, for the first time, a federal system for the regulation of the entire government securities market, including previously unregulated brokers and dealers. The primary goal of GSA was to protect investors and ensure the maintenance of a fair, honest, and liquid market.

The GSA granted the Department of the Treasury (Treasury) authority to develop and implement rules for transactions in government and agency securities effected by government securities brokers or dealers (that is, securities firms as well as other financial institutions), and to develop and implement regulations relating to the custody of government securities held by depository institutions. The rules were intended to prevent fraudulent and manipulative acts and practices and to protect the integrity, liquidity, and efficiency of the government securities market. At the same time, the rules were designed to preclude unfair discrimination among brokers, dealers, and customers. Enforcement of the rules for the GSA is generally carried out by an institution's primary regulatory organization.

The rules for the GSA had the most significant effect on those entities that were not previously subject to any form of federal registration and regulation. These entities included not only firms registered as government securities brokers or dealers but also firms registered as brokers or dealers trading in other securities and financial products. For the first time, the government securities activities of these entities were subject to the discipline of financial responsibility, customer protection, recordkeeping, and advertising requirements. For nonbank dealers, this regulation is enforced by a self-regulatory organization, the Financial Industry Regulatory Authority (FINRA), which conducts routine examinations under the oversight of the Securities and Exchange Commission (SEC).

The provisions of the GSA that had the most significant effect on government securities brokers and dealers (both bank and nonbank broker-dealers) relate to hold-in-custody repurchase agreement rules. Congress targeted this area because of abuses that had resulted in customer losses. Several requirements to strengthen customer protection were imposed: (1) written repurchase agreements must be in place, (2) the risks of the transactions must be disclosed to the customer, (3) specific repurchase securities must be allocated to and segregated for the customer, and (4) confirmations must be made and provided to the customer by the end of the day on which a transaction is initiated and on any day on which a substitution of securities occurs. For a more detailed description of the rules for the GSA requirements, see the procedures for the examination of government securities activities issued by the Board of Governors of the Federal Reserve System, or 17 CFR 400–450 for the actual text of the regulations.

Registration Exemptions

Most banks acting as government securities brokers or dealers are required to file a form known as a G-FIN. This form details the bank's capacity, the locations where government securities activities are performed, and the persons responsible for supervision. However, certain bank government securities activities are exempt from the filing requirements. Banks handling only U.S. savings bond transactions or submitting tender offers on original issue U.S. Treasury securities are exempt from registration.

Limited government securities brokerage activities are also exempt from registration under certain circumstances. Banks that engage in fewer than 500 government securities transactions annually (excluding savings bond transactions and Treasury tender offers) are exempt. Similarly, banks are exempt if they deal with a registered broker-dealer under a "networking" arrangement, assuming they meet the following conditions: (1) the transacting broker must be clearly identified, (2) bank employees perform only clerical or administrative duties and do not receive transaction-based compensation, and (3) the registered broker-dealer receives and maintains all required information on each customer. Exempt networking arrangements must be fully disclosed to the customer. Finally, banks are exempt from registration requirements if their activities are limited to purchases and sales in a fiduciary capacity or purchases and sales of repurchase or reverse repurchase agreements.

The preceding exemptions provide relief from registration, but exempt banks must comply (if applicable) with regulations addressing custodial holdings for customers (17 CFR 450). Additionally, banks effecting repurchase/reverse repurchase agreements must comply with repurchase-transaction requirements detailed in 17 CFR 403.5(d).

MUNICIPAL SECURITIES

Municipal securities are debt obligations issued by state and local governments and certain agencies and authorities. There are two broad categories of municipal bonds: general obligation bonds and revenue bonds. General obligation bonds (GOs) are backed by the full faith and credit and taxing authority of the government issuer. General obligation bonds are either limited or unlimited tax bonds. Limited tax bonds are issued by government entities whose taxing authority is limited to some extent by law or statute. For instance, a local government may face restrictions on the level of property taxes it can levy on property owners. State and local entities may also issue special tax bonds, which are supported by a specific tax. For instance, a highway project may be financed by a special gasoline tax levied to pay for the bonds. Unlimited tax bonds are issued by government entities that are not restricted by law or statute in the amount of taxes they can levy; however, there may be some political limitations.

Municipal revenue bonds are backed by a specific project or government authority, and they are serviced by fees and revenues paid by users of the government entity. Revenue bonds are backed by public power authorities, nonprofit hospitals, housing authorities, transportation authorities, and other public and quasi-public entities.

Effective March 13, 2000, well-capitalized state member banks were authorized by the Gramm-Leach-Bliley Act (GLB Act) to deal in, underwrite, purchase, and sell municipal revenue bonds without any limitations based on the bank's capital. (See 12 USC 24 (seventh).) Previously, banks were limited to only underwriting, dealing in, or investing in, without limitation, general obligation municipal bonds backed by the full faith and credit of an issuer with general powers of taxation. Member banks could invest in, but not underwrite or deal in, municipal revenue bonds, but the purchases and sales of such investment securities for any obligor were limited to 10 percent of a member bank's capital and surplus. As a result of the GLB Act amendment, municipal revenue bonds are the equivalent of type I securities for well-capitalized state member banks.[2] (See SR-01-13.) Banks that are not well capitalized may engage in more limited municipal securities activities relating to type II and type III securities. For example, banks may also deal in, underwrite, or invest in revenue bonds that are backed by housing, university, or dormitory projects.

In addition to municipal bonds, state and local governments issue obligations to meet short-term funding needs. These obligations are normally issued in anticipation of some specific revenue. The types of debt issued include tax-anticipation notes (TANs), revenue-anticipation notes (TRANs), grants-anticipation notes (GANs), bond-anticipation notes (BANs), commercial paper, and others.

Because of the large number and diverse funding needs of state and local governments (over 50,000 state and local governments have issued debt in the United States), there is a wide variety of municipal securities. Some municipal security issues have complex structures that require an increased level of technical expertise to evaluate. As with all areas of banking, dealers who invest in complex instruments are expected to understand the characteristics of the instruments and how these instruments might affect their overall risk profile. While there are some large issuers, like the states of New York and California, most issuers are small government entities that place modest amounts of debt. Many of these issues are exempt from federal, state, and local income taxes; these exemptions, in part, determine the investor base for municipal bonds.

The customer base for tax-exempt municipal securities is investors who benefit from income that is exempt from federal income tax. This group includes institutional investors, such as insurance companies, mutual funds, and retail investors, especially individuals in high income-tax brackets.

Credit Risk

Municipal securities activities involve differing degrees of credit risk depending on the financial capacity of the issuer. Larger issuers of municipal securities are rated by nationally recognized rating agencies (Moody's, S&P, etc.). Other municipalities achieve an investment-grade rating through the use of credit enhancements, usually in the form of a standby letter of credit issued by a financial institution. Banks are also involved in underwriting and placing nonrated municipal securities. Nonrated issues are typically small and are placed with a limited number of investors. Liquidity in the secondary market is limited, and bank dealers rarely carry nonrated issues in trading inventory.

Management should take steps to limit undue concentrations of credit risk arising from municipal-security underwriting and dealing. Exposure to nonrated issuers should be approved through the bank's credit-approval process with appropriate documentation to support the issuer's financial capacity. Activity in nonrated issues outside the bank's target or geographic market should also be avoided. In addition, exposure should be aggregated on a consolidated basis, taking into account additional credit

2. The Office of the Comptroller of the Currency published final amendments to its investment securities regulation (12 CFR 1) on July 2, 2001. (See 66 *Fed. Reg.* 34784.)

risk arising from traditional banking products (loans, letters of credit, etc.).

Municipal Securities Rulemaking Board

The Securities Act Amendments of 1975 (15 USC 78o-4) extended a comprehensive network of federal regulation to the municipal securities markets. Pursuant to the act, municipal securities brokers and dealers are required to register with the SEC. The act also created a separate, self-regulatory body, the Municipal Securities Rulemaking Board (MSRB), to formulate working rules for the regulation of the municipal securities industry. The Federal Reserve is required to ensure compliance with those rules as they apply to state member banks.

A bank engaged in the business of buying and selling municipal securities must register with the SEC as a municipal securities dealer if it is involved in—

- underwriting or participating in a syndicate or joint account for the purpose of purchasing securities;
- maintaining a trading account or carrying dealer inventory; or
- advertising or listing itself as a dealer in trade publications, or otherwise holding itself out to other dealers or investors as a dealer.

Generally, a bank that buys and sells municipal securities for its investment portfolio or in a fiduciary capacity is not considered a dealer.

If a bank meets the SEC's criteria for registering as a municipal securities dealer, it must maintain a separately identifiable department or division involved in municipal securities dealing that is under the supervision of officers designated by the bank's board of directors. These designated officers are responsible for municipal securities dealer activities and should maintain separate records.

The Federal Reserve conducts a separate examination of the municipal securities dealer activities in banks that engage in such activities. This examination is designed to ensure compliance with the rules and standards formulated by the MSRB. For a complete description of the activities of a municipal securities dealer and detailed procedures performed by the Federal Reserve examiners, see the *Municipal Securities Dealer Bank Examination Manual* issued by the Board of Governors of the Federal Reserve System.

REPURCHASE AGREEMENTS AND SECURITIES LENDING

Repurchase agreements (repos) play an important role in the securities markets. A repo is the simultaneous agreement to sell a security and repurchase it at a later date. Reverse repos are the opposite side of the transaction, securities purchased with a later agreement to resell. From the dealer's perspective, a repo is a financing transaction (liability), and a reverse repo is a lending transaction (asset). Overnight repos are a one-day transaction; anything else is referred to as a "term repo." Approximately 80 percent of the repo market is overnight. Although any security can be used in a repurchase transaction, the overwhelming majority of transactions involve government securities.

Securities dealers use repos as an important source of liquidity. The majority of government securities trading inventory will typically be financed with repos. Reverse repos are used to obtain securities to meet delivery obligations arising from short positions or from the failure to receive the security from another dealer. Reverse repos also are an effective and low-risk means to invest excess cash on a short-term basis.

The repo rate is a money market rate that is lower than the federal funds rate due to the collateralized nature of the transaction. Opportunities also arise to obtain below-market-rate financing. This situation arises when demand exceeds supply for a specific bond issue and it goes on "special." Dealers who own the bond or control it under a reverse repo transaction can earn a premium by lending the security. This premium comes in the form of a below-market-rate financing cost on a repo transaction.

Many of the larger dealers also engage in proprietary trading of a matched book, which consists of a moderate to large volume of offsetting repos and reverse repos. The term "matched book" is misleading as the book is rarely perfectly matched. Although profit may be derived from the capture of a bid/ask spread on matched transactions, profit is more often derived from maturity mismatches. In a falling-rate environment, traders lend long (reverse repos) and borrow short (repos). It is more difficult to profit in rising-rate environments because of the shape of the yield curve, which is usually upward-sloping. The overall size of the matched book and the length of the maturity mismatches will generally decline in a rising environment. Matched books are also used to create opportunities to control securities that may go on special, resulting in potential profit opportunities. Dealers engaging in matched-book trading provide important liquidity to the repo market.

Risk in a matched book should be minimized by establishing prudent limits on the overall size of the book, size of maturity mismatches, and restrictions on the maximum tenor of instruments. The overall risk of a matched book is usually small in relation to other trading portfolios. Maturity mismatches are generally short-term, usually 30 to 60 days, but may extend up to one year. Risk can be quickly neutralized by extending the maturity of assets or liabilities. Financial instruments (futures and forward rate agreements) can also be used to reduce risk.

Securities dealers may also engage in "dollar-roll" transactions involving mortgage-backed securities, which are treated as secured financings for accounting purposes. The "seller" of the security agrees to repurchase a "substantially identical" security from the "buyer," rather than the same security. Many of the supervisory considerations noted above for repurchase agreements also apply to dollar-roll transactions. However, if the security to be repurchased is not substantially identical to the security sold, the transaction generally should be accounted for as a sale and not as a financing arrangement. The accounting guidance for "substantially identical" is described in American Institute of Certified Public Accountants (AICPA) Statement of Position 90-3, which generally requires debt instruments to have the same primary obligor or guarantor, the same form and type, the identical contractual interest rate, the same maturity or weighted average maturity, and other factors.

In addition, securities dealers may engage in securities lending or borrowing transactions. In substance, these transactions are very similar to repo transactions except the transactions have no stated maturity. The transactions are conducted through open-ended "loan" agreements that may be terminated on short notice by the lender or borrower. Although lending transactions have historically been centered in corporate debt and equity obligations, the market increasingly involves loans of large blocks of U.S. government and federal-agency securities. To participate in this market, a bank may lend securities held in its investment account or trading account. Like repos, securities are lent to cover fails (securities sold but not available for delivery) and short sales. Collateral for the transactions can consist of other marketable securities or standby letters of credit; however, the large majority of transactions are secured by cash. Investors are willing to lend securities due to the additional investment income that can be earned by investing the cash collateral. When a securities loan is terminated, the securities are returned to the lender and the collateral to the borrower.

Credit Risk

Since repurchase agreements and securities lending transactions are collateralized, credit risk is relatively minor if properly controlled. Some dealers have underestimated the credit risk associated with the performance of the counterparty and have not taken adequate steps to ensure their control of the securities serving as collateral. The market volatility of the securities held as collateral can also add to the potential credit risk associated with the transaction.

As an added measure of protection, dealers require customers to provide excess collateral. This excess is referred to as "margin." The size of the margin will be a function of the volatility of the instrument serving as collateral and the length of the transaction. In addition to initial margin, term repos and security lending arrangements require additional margin if the value of the collateral declines below a specified level. Excess margin is usually returned to the counterparty if the value of the collateral increases. A daily "mark-to-market" or valuation procedure must be in place to ensure that calls for additional collateral are made on a timely basis. The valuation procedures should be independent of the trader and take into account the value of accrued interest on debt securities. It is important to point out that credit risk can arise from both asset transactions (reverse repos and securities borrowed) and liability transactions (repos and securities lent) because of market fluctuations in collateral provided and received. Dealers should take steps to ensure that collateral provided is not excessive.

Policies and procedures should be in place to ensure transactions are conducted only with approved counterparties. Credit-limit approvals should be based on a credit analysis of the borrower. An initial review should be performed before establishing a relationship, with periodic reviews thereafter. Credit reviews should include an analysis of the bor-rower's financial statement, capital, management, earnings, business reputation, and any other relevant factors. Analyses should be performed in an independent department of the lender institution, by persons who routinely perform credit analyses. Analyses performed solely by the person managing the repo or securities lending programs are not sufficient. Credit and concentration limits should take into account other extensions of credit by other departments of the bank or affiliates. Procedures should be established to ensure that credit and concentration limits are not exceeded without proper authorization from management.

Other Uses and Implications of Securities Lending

In addition to lending their own securities, financial institutions have become increasingly involved in lending customers' securities held in custody, safekeeping, trust, or pension accounts. These activities are typically organized within the bank's trust department. Not all institutions that lend securities or plan to do so have relevant experience. Because the securities available for lending often greatly exceed the demand, inexperienced lenders may be tempted to ignore commonly recognized safeguards. Bankruptcies of broker-dealers have heightened regulatory sensitivity to the potential for problems in this area.

Fees received on securities loans are divided between the custodial institution and the customer account that owns the securities. In situations involving cash collateral, part of the interest earned on the temporary investment of cash is returned to the borrower and the remainder is divided between the lender institution and the customer account that owns the securities.

In addition to a review of controls, examiners should take steps to ensure that cash collateral is invested in appropriate instruments. Cash should be invested in high-quality, short-term money market instruments. Longer-term floating-rate instruments may also be appropriate; however, illiquid investments and products with customized features (for example, structured notes with imbedded options) should be avoided. Several banks have reported significant losses associated with inappropriate investments in securities lending areas.

Securities-Lending Capacity

Securities lending may be done in various capacities and with differing associated liabilities. It is important that all parties involved understand in what capacity the lender institution is acting. The relevant capacities are described below.

Principal

A lender institution offering securities from its own account is acting as principal. A lender institution offering customers' securities on an undisclosed basis is also considered to be acting as principal.

Agent

A lender institution offering securities on behalf of a customer-owner is acting as an agent. To be considered a bona fide or "fully disclosed" agent, the lending institution must disclose the names of the borrowers to the customer-owners and the names of the customer-owners to the borrowers (or give notice that names are available upon request). In all cases, the agent's compensation for handling the transaction should be disclosed to the customer-owner. Undisclosed agency transactions, that is, "blind brokerage" transactions in which participants cannot determine the identity of the contra party, are treated as if the lender institution were the principal.

Directed Agent

A lender institution that lends securities at the direction of the customer-owner is acting as a directed agent. The customer directs the lender institution in all aspects of the transaction, including to whom the securities are loaned, the terms of the transaction (rebate rate and maturity/call provisions on the loan), acceptable collateral, investment of any cash collateral, and collateral delivery.

Fiduciary

A lender institution that exercises discretion in offering securities on behalf of and for the benefit of customer-owners is acting as a fiduciary. For supervisory purposes, the underlying relationship may be as agent, trustee, or custodian.

Finder

A finder brings together a borrower and a lender of securities for a fee. Finders do not take possession of the securities or collateral. Delivery of securities and collateral is directly between the borrower and the lender, and the finder does not become involved. The finder is simply a fully disclosed intermediary.

MONEY MARKET INSTRUMENTS

In addition to bank-eligible securities activities, banks may engage in a substantial volume of trading in money market instruments. Federal funds, banker's acceptances, commercial paper, and certificates of deposit are forms of money market instruments. While these instruments may be used as part of the overall funding strategy, many firms actively engage in discretionary or proprietary trading in these instruments. As in matched-book repo activities, profits from trading money market instruments are derived from the bid/ask spread on matched transactions and the net interest spread from maturity mismatches.

This activity may result in overall money market arbitrage. Arbitrage is the coordinated purchase and sale of the same security or its equivalent, for which there is a relative price imbalance in the market. The objective of such activity is to obtain earnings by taking advantage of changing yield spreads. Arbitrage can occur with items such as Eurodollar CDs, banker's acceptances, and federal funds, and with financial instruments such as futures and forwards.

Although the risk of money market trading is relatively straightforward, the potential risk can be significant based on the volume of trading and size of the mismatches. Despite the potential risk, these activities may offer attractive profit opportunities if effectively controlled. Short-term interest-rate markets are very liquid, and risk can be quickly neutralized by changing the maturity profile of either assets or liabilities. Financial instruments (such as futures and forward rate agreements) can also be an effective tool to manage risk. Money market trading may be managed as a separate product line or may be integrated with trading in other interest-rate products (such as swaps, caps, or floors). Examiners should take steps to ensure that appropriate limits are in place for money market trading, including restrictions on aggregate notional size, the size of maturity mismatches, and the maximum tenor of instruments.

Federal Funds

Commercial banks actively use the federal funds market as a mechanism to manage fluctuations in the size and composition of their balance sheet. Federal funds are also an efficient means to manage reserve positions and invest excess cash on a short-term basis. Although transactions are generally unsecured, they can also be secured. The majority of transactions are conducted overnight; however, term transactions are also common. Federal funds trading will often involve term transactions in an attempt to generate positive net interest spread by varying the maturities of assets and liabilities.

Banks have traditionally engaged in federal funds transactions as principal, but an increasing number of banks are conducting business as agent. These agency-based federal funds transactions are not reported on the agent's balance sheet. Dealer banks may also provide federal funds clearing services to their correspondent banks.

Banker's Acceptances

Banker's acceptances are time drafts drawn on and accepted by a bank. They are the customary means of effecting payment for merchandise sold in import-export transactions, as well as a source of financing used extensively in international trade. Banker's acceptances are an obligation of the acceptor bank and an indirect obligation of the drawer. They are normally secured by rights to the goods being financed and are available in a wide variety of principal amounts. Maturities are generally less than nine months. Acceptances are priced like Treasury bills, with a discount figured for the actual number of days to maturity based on a 360-day year. The bank can market acceptances to the general public but must guarantee their performance.

Commercial Paper

Commercial paper is a generic term that is used to describe short-term, unsecured promissory notes issued by well-recognized and generally sound corporations. The largest issuers of commercial paper are corporations, bank holding companies, and finance companies, which use the borrowings as a low-cost alternative to bank financing. Commercial paper is exempt from registration under the Securities Act of 1933 if it meets the following conditions:

- prime quality and negotiable
- not ordinarily purchased by the general public
- issued to facilitate current operational business requirements
- eligible for discounting by a Federal Reserve Bank
- maturity does not exceed nine months

Actively traded commercial paper is ordinarily issued in denominations of at least $100,000 and often in excess of $1 million. Commercial paper issuers usually maintain unused bank credit lines to serve as a source of back-up liquidity or contingency financing, principally in the form of standby letters of credit. Major commercial paper issuers are rated by nationally recognized rating agencies (Moody's, S&P, and others). Other issuers achieve higher ratings through the use of a credit enhancement, usually in the form of a standby letter of credit issued by a financial institution.

Based on Supreme Court rulings, commercial paper was considered a security for purposes of the former Glass-Steagall Act. As a result, banks were generally prohibited from underwriting and dealing in commercial paper. Despite this restriction, banks participated in this market in an "agency capacity." When establishing a commercial paper dealership, many of the larger banks pursued business through an aggressive interpretation of an agency-transaction role. In practice, bank dealers engage in riskless-principal or best-efforts placement of commercial paper. Taking this logic a step further, others actively engage in competitive bidding and intraday distribution of newly issued paper. Because the paper settles on a same-day basis, the transactions are never part of the official end-of-day records of the bank. Although this technical point has been the subject of discussion, the practice has not been subject to regulatory challenge.

Commercial paper may be issued as an interest-bearing instrument or at a discount. Market trades are priced at a current yield, net of accrued interest due the seller or, if the commercial paper was issued at a discount, at a discount figured for the actual number of days to maturity based on a 360-day year.

The sale of commercial paper issued by bank affiliates must conform to legal restrictions and avoid conflicts of interest. Each certificate and confirmation should disclose the facts that the commercial paper is not a deposit and is not insured by the Federal Deposit Insurance Corporation.

Certificates of Deposit

Negotiable certificates of deposit (CDs) issued by money-center banks are actively traded in denominations of $100,000 to $1 million. Interest generally is calculated on a 360-day year and paid at maturity. Secondary-market prices are computed based on current yield, net of accrued interest due the seller. Eurodollar CDs trade like domestic CDs except their yields are usually higher and their maturities are often longer.

Credit-Risk and Funding Concentrations

In addition to market risk, money market policies and guidelines should recognize the credit risk inherent in these products. Federal funds sold and deposit placements are essentially unsecured advances. To avoid undue concentrations of credit risk, activity with these products should be limited to approved counterparties. Limits should be established for each prospective counterparty. Tenor limits should also be considered to reduce the potential for credit deterioration over the life of the transaction. The size of limits should be based on both anticipated activity and the counterparty's financial capacity to perform. The credit analysis should be performed by qualified individuals in a credit department that is independent from the money market dealing function. In assessing the creditworthiness of other organizations, institutions should not rely solely on outside sources, such as standardized ratings provided by independent rating agencies, but should perform their own analysis of a counterparty's or issuer's financial strength. At a minimum, limits should be reassessed and credit analyses updated annually. Once established, limits should be monitored with exceptions documented and approved by the appropriate level of senior management. Exposure should also be aggregated on a consolidated basis with any other credit exposure arising from other product areas. Exposure to foreign bank counterparties should also be aggregated by country of domicile to avoid country-risk concentrations. The limit structure should be reviewed to ensure compliance with the requirements of Regulation F, Limitations on Interbank Liabilities, which places prudent limits on credit exposure to correspondent banks.

Maintaining a presence in the wholesale funding markets requires a strong reputation and increases potential liquidity risk. The prolonged use of a large volume of purchased funds to support a money market trading operation could also reduce the capacity to tap this market, if needed, for core funding. Guidelines should be in place to diversify sources of funding. Contingency plans should include strategies to exit or reduce the profile in these markets if the situation warrants.

OPERATIONS AND INTERNAL CONTROLS

A bank dealer's operational functions should be designed to regulate the custody and movement of securities and to adequately account for trading transactions. Because of the dollar volume and speed of trading activities, operational inefficiencies can quickly result in major problems.

Sound Practices for Front- and Back-Office Operations

Bank dealer activities vary significantly among financial institutions, depending on the size and complexity of the trading products; trading, back-office, and management expertise; and the sophistication of systems. As a result, practices, policies, and procedures in place in one institution may not be necessary in another. The adequacy of internal controls requires sound judgment on the part of the examiner. The following is a list of policies and procedures that should be reviewed:

- Every organization should have comprehensive policies and procedures in place that describe the full range of bank dealer activities performed. These documents, typically organized into manuals, should at a minimum address front- and back-office operations; reconciliation guidelines and frequency; revaluation and accounting guidelines; descriptions of accounts; broker policies; a code of ethics; and the risk-measurement and -management methods, including a comprehensive limit structure.
- Every institution should have existing policies and procedures to ensure the segregation of duties among the trading, control, and payment functions.
- Revaluation sources should be independent from the traders for accounting purposes, risk oversight, and senior management reporting, although revaluation of positions may be conducted by traders to monitor positions.
- Trader and dealer telephone conversations should be taped to facilitate the resolution of disputes and to serve as a valuable source of information to auditors, managers, and examiners.
- Trade tickets and blotters (or their electronic equivalents) should be timely and complete to allow for easy reconciliation and for appropriate position and exposure monitoring. The volume and pace of trading may warrant virtually simultaneous creation of these records in some cases.
- Computer hardware and software applications must have the capacity to accommodate the

current and projected level of trading activity. Appropriate disaster-recovery plans should be tested regularly.
- Every institution should have a methodology to identify and justify any off-market transactions. Ideally, off-market transactions would be forbidden.
- A clear institutional policy should exist for personal trading. If such trading is permitted at all, procedures should be established to avoid even the appearance of conflicts of interest.
- Every institution should ensure that the management of after-hours and off-premises trading, if permitted at all, is well documented so that transactions are not omitted from the automated blotter or the bank's records.
- Every institution should ensure that staff is both aware of and complies with internal policies governing the trader-broker relationship.
- Every institution that uses brokers should monitor the patterns of broker usage, be alert to possible undue concentrations of business, and review the list of approved brokers at least annually.
- Every institution that uses brokers should establish a policy that minimizes name substitutions of brokered transactions. All such transactions should be clearly designated as switches, and relevant credit authorities should be involved.
- Every institution that uses brokers for foreign-exchange transactions should establish a clear statement forbidding the lending or borrowing of brokers' points as a method to resolve discrepancies.
- Every organization should have explicit compensation policies to resolve disputed trades for all traded products. Under no circumstances should "soft-dollar" (the exchange of services in lieu of dollar compensation) or off-the-books compensation be permitted for dispute resolution.
- Every institution should have know-your-customer policies, and they should be understood and acknowledged by trading and sales staff.
- The designated compliance officer should perform a review of trading practices at least annually. In institutions with a high level of trading activity, interim reviews may be warranted.
- The organization should have an efficient confirmation-matching process that is fully independent from the dealing function. Documentation should be completed and exchanged as close to completion of a transaction as possible.
- Auditors should review trade integrity and monitoring on a schedule in accordance with its appropriate operational-risk designation.
- Organizations that have customers who trade on margin should establish procedures for collateral valuation and segregated custody accounts.

Fails

In some cases, a bank may not receive or deliver a security by settlement date. "Fails" to deliver for an extended time or a substantial number of cancellations are sometimes characteristic of poor operational control or questionable trading activities.

Fails should be controlled by prompt reporting and follow-up procedures. The use of multicopy confirmation forms enables operational personnel to retain and file a copy by settlement date and should allow for prompt fail reporting and resolution.

Revaluation

The frequency of independent revaluation should be driven by the level of an institution's trading activity. Trading operations with high levels of activity may need to perform daily revaluation; however, it is important to note that independent revaluations are less critical when inventory is turning over quickly or end-of-day positions are small. In these situations, the majority of profit and loss is realized rather than unrealized. Only unrealized profit and loss on positions carried in inventory are affected by a revaluation. At a minimum, every institution should conduct an independent revaluation at the end of each standard accounting period (monthly or quarterly). There will be situations when certain securities will be difficult to price due to lack of liquidity or recent trading activity. If management relies on trader estimates in these situations, a reasonableness test should be performed by personnel who are independent from the trading function. A matrix-pricing approach may also be employed. This involves the use of prices on similar securities (coupon, credit quality, and tenor) to establish market prices.

Control of Securities

Depository institutions need to adopt procedures to ensure that ownership of securities is adequately documented and controlled. While this documentation and control once involved taking physical possession of the securities either directly or through a third-party custodian, the securities markets are quickly moving to a book-entry system. In this context, safekeeping is more of a concept than a reality. As the markets change, documenting the chain of ownership becomes the primary mechanism to prevent losses arising from a counterparty default. This documentation involves the matching of incoming and outgoing confirmations and frequent reconcilements of all accounts holding securities (Federal Reserve, customer, custodian, and other dealers). When the dealer holds securities on behalf of its customers, similar safeguards also need to be in place. Although this documentation process can be burdensome, it is necessary to protect a dealer's interest in securities owned or controlled. Many active dealers have automated the reconcilement and matching process. This reduces the potential for human error and increases the likelihood that exceptions can be uncovered and resolved quickly.

Because of the relatively short periods of actual ownership associated with repurchase agreements, potential losses could be significant if prudent safeguards are not followed. Significant repo volume or matched-book trading activities only heighten this concern. To further protect their interests, dealers should enter into written agreements with each prospective repurchase-agreement counterparty. Although the industry is moving toward standardized master agreements, some degree of customization may occur. The agreements should be reviewed by legal counsel for their content and compliance with established minimum documentation standards. In general, these agreements should specify the terms of the transaction and the duties of both the buyer and seller. At a minimum, provisions should cover the following issues:

- acceptable types and maturities of collateral securities
- initial acceptable margin for collateral securities of various types and maturities
- margin maintenance, call, default, and sellout provisions
- rights to interest and principal payments
- rights to substitute collateral
- individuals authorized to transact business on behalf of the depository institution and its counterparty

Written agreements should be in place before commencing activities.

TRADING AND CAPITAL-MARKETS ACTIVITIES MANUAL

The *Trading and Capital-Markets Activities Manual*, developed by the Federal Reserve System, is a valuable tool to help examiners understand the complex and often interrelated risks arising from capital-markets activities. The products addressed in the previous subsections and their associated risks are covered in greater detail in the manual.

As noted in the preceding sections, and further addressed in the *Trading and Capital-Markets Activities Manual*, other trading instruments could be included in the bank dealer or money market trading operation. Financial instruments such as futures and forward rate agreements are often used to modify or hedge the risk associated with cash instruments (dealer inventory and money market positions). The bank dealer may also be involved in other instruments including asset-backed securities (mortgage-backed and consumer-receivable-backed). Other departments of the bank may also use securities products as part of an unrelated trading activity. For example, interest-rate-swap traders often use cash bonds to hedge or modify market-risk exposure. In this capacity, the swap desk would be a customer of the government securities dealer. These overlaps in product focus and usage make it critical for examiners to understand the organizational structure and business strategies before establishing examination scope.

OTHER ISSUES

Intercompany Transactions

Examiners should review securities and repurchase-agreement transactions with affiliates to determine compliance with sections 23A and 23B of the Federal Reserve Act. Money market transactions may also be subject to limitations under section 23A; however, these restrictions generally do not apply to transactions between bank subsidiaries that are80 percent or more commonly owned by a bank holding company. Intercompany transactions between securities underwriting affiliates and their bank affiliates should be carefully reviewed to ensure compliance with Board operating standards and sections 23A and 23B.

Agency Relationships

Many dealer banks engage in securities transactions only in an agency capacity. Acting as an agent means meeting customers' investment needs without exposing the firm to the price risk associated with dealing as principal. Risk is relatively low as long as appropriate disclosures are made and the bank does not misrepresent the nature or risk of the security.

Agency-based federal funds transactions are also becoming more common. By serving only as an agent to facilitate the transaction, a bank can meet its correspondent's federal funds needs without inflating the balance sheet and using capital. Examiners should review agency-basedmoney market transactions to ensure that the transactions are structured in a manner that insulates the bank from potential recourse, either moral or contractual. If legal agreements are not structured properly, the courts could conclude that the agent bank was acting a principal. In this situation, the loss could be recognized by the agent bank, not its customer.

Although no single feature can determine whether an agency relationship really exists, the courts have recognized a variety of factors in distinguishing whether the persons to whom "goods" were transferred were buyers or merely agents of the transferor. Although some of these distinguishing factors may not apply to federal-funds transactions because they involve the transfer of funds rather than material goods, some parallels can be drawn. An agency relationship would appear to encompass, although not necessarily be limited to, the following elements:

- The agent bank must agree to act on behalf of the seller of the federal funds ("seller") and not on its own behalf.
- The agent should fully disclose to all parties to the transaction that it is acting as agent on behalf of the seller and not on its own behalf.
- The seller, not the agent bank, must retain title to the federal funds before their sale to a purchasing institution.
- The seller, not the agent bank, must bear the risk of loss associated with the federal-funds sale.
- The agent bank's authority in selling federal funds and accounting for these sales to the seller should be controlled by the seller or by some guidelines to which the seller has agreed. The agent bank should sell only to those banks stipulated on a list of banks approved, reviewed, and confirmed periodically by the seller bank.
- The agent bank should be able to identify the specific parties (sellers and purchasers) to a federal-funds sale and the amount of each transaction for which the agent has acted.
- The agent bank's compensation should generally be based on a predetermined fee schedule or percentage rate (for example, a percentage based on the number or size of transactions). The agent should generally not receive compensation in the form of a spread over a predetermined rate that it pays to the seller. (If the agent bank's compensation is in the form of a spread over the rate it pays to the seller, this situation would appear to be more analogous to acting as a principal and suggests that the transactions should be reported on the "agent's" balance sheet.)

By structuring agency agreements to include provisions that encompass these factors and by conducting agency activities accordingly, agent banks can lower the possibility that they would be considered a principal in the event of a failure of a financial institution that had purchased funds through the agent. Generally, as a matter of prudent practice, each bank acting as an agent should have written agreements with principals encompassing the above elements and have a written opinion from legal counsel as to the bona fide nature of the agency relationships.

Selling through an agent should not cause a bank to neglect a credit evaluation of the ultimate purchasers of these funds. Under the more traditional mode of conducting federal-funds transactions, banks sell their federal funds to other banks, which in many instances are larger regional correspondents. These correspondent banks in turn may resell the federal funds to other institutions. Since the correspondent is acting as a principal in these sales, the banks selling the funds to the correspondent are generally not concerned about the creditworthiness of those purchasing the federal funds from the correspondent/principal. Rather, the original selling banks need to focus solely on the creditworthiness of their correspondent banks, with which they should be quite familiar.

However, when conducting federal-funds sales through an agent, selling banks, in addition to considering the financial condition of their agent, should also subject the ultimate purchasing banks to the same type of credit analysis that would be considered reasonable and prudent if the seller banks were lending directly to the ultimate borrowers rather than through agents. Banks selling federal funds through agents should not relinquish their credit-evaluation responsibilities to their agent banks.

REPORTING

Securities held for trading purposes and the income and expense that results from trading activities should be isolated by specific general ledger or journal accounts. The balances in those accounts should be included in the appropriate reporting categories for regulatory reporting.

Instructions for the Consolidated Report of Condition and Income (call report) require that securities, derivative contracts, and other items held in trading accounts be reported consistently at market value, or at the lower of cost or market value, with unrealized gains and losses recognized in current income. For further detail, refer to the glossary section of the call report instructions under "trading account." With either method, the carrying values of trading-security inventories should be evaluated periodically (monthly or quarterly), based on current market prices. The increase or decrease in unrealized appreciation or depreciation resulting from that revaluation should be credited or charged to income. Periodic independent revaluation is the most effective means of measuring the trading decisions of bank management.

For reporting purposes, the trading department's income should include not only revaluation adjustments, but also profits and losses from the sale of securities, and other items related to the purchase and sale of trading securities. Interest income from trading assets, salaries, commissions, and other expenses should be excluded from trading income for reporting purposes; however, these items should be considered by management when evaluating the overall profitability of the business.

When the lender institution is acting as a fully disclosed agent, securities-lending activities need not be reported on the call report. However, lending institutions offering indemnification against loss to their customer-owners should report the associated contingent liability gross in Schedule RC-L as "other significant commitments and contingencies."

Recordkeeping and Confirmation Rules

Regulation H contains rules establishing uniform standards for bank recordkeeping, confirmation, and other procedures in executing securities transactions for bank customers. The regulation applies, in general, to those retail commercial activities where the bank effects securities transactions at the direction and for the account of customers. The purpose of the rules is to ensure that purchasers of securities are provided adequate information concerning a transaction and that adequate records and controls are maintained for securities transactions. Under the rules, banks are required to maintain certain detailed records concerning securities transactions, to provide written confirmations to customers under certain circumstances, and to establish certain written policies and procedures. The requirements generally do not apply to banks that make 200 or fewer securities transactions a year for customers (exclusive of transactions in U.S. government and agency obligations) and to transactions subject to the requirements of the MSRB.

Due Bills

A "due bill" is an obligation that results when a firm sells a security or money market instrument and receives payment, but does not deliver the item sold. Due bills issued should be considered as borrowings by the issuing firm, and alternatively, due bills received should be considered as lending transactions. Dealers should not issue due bills as a means of obtaining operating funds or when the underlying security can be delivered at settlement. Customers of the dealer enter transactions with an implicit understanding that securities transactions will be promptly executed and settled unless there is a clear understanding to the contrary. Consequently, dealers should promptly disclose the issuance of a due bill to a customer when funds are taken but securities or money market instruments are not delivered to the customer. Such disclosure should reference the applicable transaction; state the reason for the creation of a due bill; describe any collateral securing the due bill; and indicate that to the extent the market value of the collateral is insufficient, the customer may be an unsecured creditor of the dealer.

Due bills that are outstanding for more than three days and are unsecured could be construed as funding and should be reported as "liabilities for borrowed monies" on the call report. These balances are subject to reserve requirements imposed by Regulation D.

ESTABLISHING SCOPE

Obtaining an overview of the organization, management structure, products offered, and control environment is a critical step in the examination process. Based on this assessment, an examiner should determine the appropriate resources and skill level. In situations where an institution is active in either the government or municipal securities markets, it is essential to allocate additional resources for GSA and MSRB compliance. The assigned examiners should be familiar with the provisions of GSA and MSRB as well as with the related examination procedures. For active proprietary trading units, it is important to assign examiners who have a reasonable working knowledge of the concepts outlined in the *Trading Activities Manual*.

1. To determine if the policies, practices, procedures, and internal controls regarding bank dealer activities are adequate.
2. To determine if bank officers are operating in conformance with the established guidelines.
3. To evaluate the trading portfolio for credit quality and marketability.
4. To determine the scope and adequacy of the audit compliance functions.
5. To determine compliance with applicable laws and regulations.
6. To ensure investor protection.
7. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

1. If selected for implementation, complete or update the Bank Dealer Activities section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by 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 deficiencies noted in the latest review done by internal/external auditors from the examiner assigned "Internal Control," and determine if corrections have been accomplished.
4. Request that the bank provide the following schedules:
   a. An aged schedule of securities that have been acquired as a result of underwriting activities.
   b. An aged schedule of trading account securities and money market instruments held for trading or arbitrage purposes. Reflect commitments to purchase and sell securities and all joint account interests.
   c. A schedule of short-sale transactions.
   d. An aged schedule of due bills.
   e. A list of bonds borrowed.
   f. An aged schedule of "fails" to receive or deliver securities on unsettled contracts.
   g. A schedule of approved securities borrowers and approved limits.
   h. A schedule of loaned securities.
   i. A schedule detailing account names and/or account numbers of the following customer accounts:
      - Own bank trust accounts.
      - Own bank permanent portfolio.
      - Affiliated banks' permanent portfolio accounts.
      - Personal accounts of employees of other banks.
      - Accounts of brokers or other dealers.
      - Personal accounts of employees of other brokers or dealers.
   j. A list of all joint accounts entered into since the last examination.
   k. A list of underwriting since the last examination and whether such securities were acquired by negotiation or competitive bid.
   l. A list of all financial advisory relationships.
5. Agree balances of appropriate schedules to general ledger and review reconciling items for reasonableness.
6. Determine the extent and effectiveness of trading policy supervision by:
   a. Reviewing the abstracted minutes of meetings of the board of directors and/or of any appropriate committee.
   b. Determining that proper authorization for the trading officer or committee has been made.
   c. Ascertaining the limitations or restrictions on delegated authorities.
   d. Evaluating the sufficiency of analytical data used in the most recent board or committee trading department review.
   e. Reviewing the methods of reporting by department supervisors and internal auditors to ensure compliance with established policy and law.
   f. Reaching a conclusion about the effectiveness of director supervision of the bank's trading policy. Prepare a memo for the examiner assigned "Duties and Responsibilities of Directors" stating your conclusions. All conclusions should be supported by factual documentation.

(Before continuing, refer to steps 14 and 15. They should be performed in conjunction with the remaining examination steps.)

7. Ascertain the general character of underwriting and direct placement activities and the effectiveness of department management by reviewing underwriter files and ledgers, committee reports and offering statements to determine:
   a. The significance of underwriting activities and direct placements of type III securities as reflected by the volume of sales and profit or loss on operations. Compare current data to comparable prior periods.
   b. Whether there is a recognizable pattern in:

- The extent of analysis of materialinformation relating to the ability of the issuer to service the obligation.
- Rated quality of offerings.
- Point spread of profit margin for unrated issues.
- Geographic distribution of issuers.
- Syndicate participants.
- Bank's trust department serving as corporate trustee, paying agent and transfer agent for issuers.
- Trustee, paying agent and transfer agent business being placed with institutions that purchase a significant percentage of the underwriter or private placement offering.

c. The volume of outstanding bids. Compare current data to comparable prior periods.

d. The maturity, rated quality and geographic distribution of takedowns from syndicate participations.

e. The extent of transfer to the bank's own or affiliated investment or trading portfolios or to trust accounts and any policies relating to this practice.

8. Determine the general character of trading account activities and whether the activities are in conformance with stated policy by reviewing departmental reports, budgets and position records for various categories of trading activity and determining:
   a. The significance of present sales volume compared to comparable prior periods and departmental budgets.
   b. Whether the bank's objectives are compatible with the volume of trading activity.
9. Review customer ledgers, securities position ledgers, transaction or purchase and sales journals and analyze the soundness of the bank's trading practices by:
   a. Reviewing a representative sample of agency and contemporaneous principal trades and determining the commission and price mark-up parameters for various sizes and types of transactions.
   b. Selecting principal transactions that have resulted in large profits and determining if the transaction involved:
      - ''Buy-backs'' of previously traded securities.
      - Own bank or affiliated bank portfolios.
      - A security that has unusual quality and maturity characteristics.
   c. Reviewing significant inventory positions taken since the prior examination and determining if:
      - The quality and maturity of the inventory position was compatible with prudent banking practices.
      - The size of the position was within prescribed limits and compatible with a sound trading strategy.
   d. Determining the bank's exposure on offsetting repurchase transactions by:
      - Reviewing the maturities of offsetting re-po and reverse re-po agreements to ascertain the existence, duration, amounts and strategy used to manage unmatched maturity ''gaps'' and extended (over 30 days) maturities.
      - Reviewing records since the last examination to determine the aggregate amounts of:
        — Matched repurchase transactions.
        — Reverse re-po financing extended to one or related firms(s).
      - Performing credit analysis of significant concentrations with any single or related entity(ies).
      - Reporting the relationship of those concentrations to the examiners assigned ''Concentration of Credits'' and ''Funds Management.''
10. Determine the extent of risk inherent in trading account securities which have been in inventory in excess of 30 days and:
    a. Determine the dollar volume in extended holdings.
    b. Determine the amounts of identifiable positions with regard to issue, issuer, yield, credit rating, and maturity.
    c. Determine the current market value for individual issues which show an internal valuation mark-down of 10 percent or more.
    d. Perform credit analyses on the issuers of non-rated holdings identified as significant positions.
    e. Perform credit analyses on those issues with valuation write-downs considered significant relative to the scope of trading operations.
    f. Discuss plans for disposal of slow moving inventories with management and determine the reasonableness of those plans in light of current and projected market trends.

11. Using an appropriate technique, select issuesfrom the schedule of trading account inventory. Test valuation procedures by:
    a. Reviewing operating procedures and supporting workpapers and determining if prescribed valuation procedures are being followed.
    b. Comparing bank prepared market prices, as of the most recent valuation date, to an independent pricing source (use trade date "bid" prices).
    c. Investigating any price differences noted.
12. Using an appropriate technique, select transactions from the schedule of short sales and determine:
    a. The degree of speculation reflected by basis point spreads.
    b. Present exposure shown by computing the cost to cover short sales.
    c. If transactions are reversed in a reasonable period of time.
    d. If the bank makes significant use of due-bill transactions to obtain funds for its banking business:
        - Coordinate with the examiner assigned "Review of Regulatory Reports" to determine if the bank's reports of condition reflect due bill transactions as "liabilities for borrowed money."
        - Report amounts, duration, seasonal patterns and budgeted projections for due bills to the examiner assigned "Funds Management."
13. If the bank is involved in agency-based federal funds activity:
    a. At the beginning or in advance of each examination of a banking organization which has been acting as an agent in the purchase and sale of federal funds for other institutions, examiners should obtain certain information which will help them determine the nature and extent of this activity. The information should include:
        - A brief description of the various types of agency relationships (i.e., involving federal funds or other money market activities) and the related transactions.
        - For each type of agency relationship, copies of associated forms, agency agreements, documents, reports and legal opinions. In addition, if the banking organization has documented its analysis of the risks associated with the activity, a copy of the analysis should be requested by the examiner.
        - For each type of agency relationship, a summary of the extent of the activity including:
            — The number of institutions serviced as principals.
            — The size range of the institutions (i.e., institutions serviced have total assets ranging from $______ to $______).
            — General location of sellers and purchasers serviced under agency relationships (i.e., New York State, Midwest, etc.)
            — Estimate of average daily volume of federal funds or money market instruments purchased and sold under agency relationships and the high and low volume over the period since the last examination inquiry (or since activity was begun, if more recent).
            — Names of individuals in the bank that are responsible for these agency relationships.
        - A historical file of this information should be maintained in order to determine the nature, extent and growth of these activities over time.
    b. Once the examination work in this area has been started, the examiner should attempt to discern any situation, activity or deficiency in this area that might suggest that an agency relationship does *not* actually exist. A negative response to the following examination guidelines section dealing with agency agreements may signal such a deficiency. In addition, any other money market agency relationships that involve new or unusual financial transactions should be evaluated to determine the nature of the risks involved and compliance, to the extent applicable, with the guidelines.
    c. The examiner should determine that the banking organization's written policies, procedures, and other documentation associated with this activity are consistent with the Federal Reserve System's Examination Guidelines. If the bank does not have written policies the examiner should strongly advise that they be developed due to the complex nature of

this activity and the potential risks associated with it.

d. After reviewing the policies, procedures, and appropriate documentation, the examiner should be able to respond positively to the following questions:
   - Banking organizations acting as *agents in the sale of federal funds*[1]
     — Has this form of activity been approved by the board of directors?
     — Are the bank's individual agency arrangements and transactions:
       - supported by written agency agreements, and
       - reviewed and approved by appropriate officers?
     — Do the written agency agreements that support this activity include provisions indicating that (a negative answer may indicate that the bank is not in fact an agent):
       - the agent bank will be acting *on behalf of the original or principal seller of federal funds ("seller")* in conducting these activities and not on the agent bank's own behalf?
       - the agency relationship will be fully disclosed to all banks involved in the transactions?
       - the seller, and not the agent bank, must retain legal title to the federal funds before they are sold to a third party bank?
       - the seller, and not the agent bank, bears the risk of loss?
       - the agent bank's authority in selling federal funds and in accounting for this activity to the seller should be controlled by the seller or by standards to which it has agreed? To implement this, does the agreement or its attachments include the following seller-approved items:
         1. lists of banks to whom the agent may sell federal funds,[2] and
         2. limits on the amounts that can be sold to these banks?
     — Does the agent have a written opinion from its legal counsel as to the bona fide nature of the agency relationship?
     — Does the accounting and reporting system of the agent bank *enable* it to account for the federal funds transactions on a period basis (i.e., at least weekly) to the sellers? (Although more frequent accounting may not be required by the sellers, the agent on any day should have the capacity to identify for the seller the banks to whom the seller's funds have been sold.)
     — Does the agent's accounting system identify *each bank* which has purchased federal funds from a particular seller bank and include (at least) the following information for *each bank* in which the funds are being invested?[3]
       - information to clearly identify the name and location of the bank (or other entity)
       - amount of federal funds sold and amount of interest earned
       - terms of transaction, and maturity date
       - lending limits agreed to
     — Does the agent bank actually disclose to banks or other organizations that are part of these agency-based transactions that it is acting as agent?
     — Is the agent bank's compensation in the form of a predetermined fee schedule or percentage rate based, for example, on the size of transactions, as opposed to compensation in the form of a spread over the rate that it pays to the seller bank? (If the agent bank's compen-

1. Although it is conceivable that a purchaser could engage an agent to *obtain* federal funds on its behalf, these guidelines focus primarily on situations where the seller has engaged an agent to sell federal funds on its behalf because the associated risks of such transactions are borne by the sellers and their agents.

2. Seller banks could conceivably design their lists of approved banks to encompass a large number of financially sound institutions and still be considered to be fulfilling this supervisory requirement.

3. The entities referred to as "ultimate purchasers" or "ultimate borrowers" are those that have the *responsibility to repay* the original seller bank, and not any intervening agents that may pass on the federal funds to these purchasers.

sation is in the form of a spread over the rate it pays to the selling bank, this situation would appear to be more akin to acting as an intermediary and suggests that the transactions should be reported on its balance sheet.)

- Banking organizations that are involved in agency-based federal funds relationships as *sellers*
  - — Does the bank support its transactions with written agency agreements?
  - — Does the seller bank evaluate the credit worthiness of the ultimate borrowers of federal funds and establish limits for each and are these limits periodically reviewed at least every six months?[3,4]
  - — Does the bank periodically (i.e., at least weekly) receive an accounting from the agent which includes the following information for *each bank* to whom the seller bank's federal funds were sold?
    - information to identify name and location of bank
    - amount of federal funds sold and interest earned
    - federal funds sales limits agreed to (if the seller bank is a principal)
  - — Is the bank's management and board of directors aware of and have they approved the agency relationship?
- Do internal and/or external auditors periodically review the policies, procedures, and internal controls associated with this activity and the activity's impact on the earnings and financial condition of the banking organization? Is their evaluation reported to management? (Applies to banks acting as *agents* in the sale of federal funds, *and* those banks involved as *sellers* of federal funds.)
- In addition to the items considered above, the examiner should determine what the impact of these transactions has been on the bank's earnings and financial condition. If the impact has been negative, or if the answer to any of the above questions is negative, the examiner should discuss these matters with bank management and seek remedial action.

14. Analyze the effectiveness of operational controls by reviewing recent cancellations and fail items that are a week or more beyond settlement date and determine:
    a. The amount of extended fails.
    b. The planned disposition of extended fails.
    c. If the control system allows a timely, productive follow-up on unresolved fails.
    d. The reasons for cancellations.
    e. The planned disposition of securities that have been inventoried prior to the recognition of a fail or a cancellation.
15. Determine compliance with applicable laws, rulings, and regulations by performing the following for:
    a. *12 CFR 1.3—Eligible Securities:*
       - Review inventory schedules of underwriting and trading accounts and determine if issues whose par value is in excess of 10 percent of the bank's captial and unimpaired surplus are type I securities.
       - Determine that the total par value of type II investments does not exceed 10 percent of the bank's capital and unimpaired surplus, based on the combination of holdings and permanent portfolio positions in the same securities.
       - Elicit management's comments and review underwriting records on direct placement of type III securities, and determine if the bank is dealing in type III securities for its own account by ascertaining if direct placement issues have been placed in own bank or affiliated investment portfolios or if underwriting proceeds were used to reduce affiliate loans.
    b. *Section 23A of the Federal Reserve Act (12 USC 371(c) and 375)—Preferential Treatment:* Obtain a list of domestic affiliate relationships and a list of directors and principal officers and their business interests from appropriate examiners and determine whether transactions, include securities clearance services, involving affiliates, insiders or their

4. This requirement is intended to mean that seller banks should conduct the type of credit analysis that would be considered reasonable and prudent for a direct federal funds activity (i.e., those federal funds activities not conducted through agents).

interests are on terms less favorable to the bank than those transactions involving unrelated parties.

c. *Regulation D (12 CFR 204.2)—Due Bills:*
   - Review outstanding due bills and determine if:
     — The customer was informed that a due bill would be issued instead of the purchased security.
     — Safekeeping receipts are sent to safekeeping customers only after the purchased security has been delivered.
   - Review due bills outstanding over three business days and determine if they are collateralized or properly reserved.
   - Review collateralized due bills and determine if the liability is secured by securities of the same type and of comparable maturity and with a market value at least equal to that of the security that is the subject of the due bill.

d. *Regulation H (12 CFR 208.8(k))—Recordkeeping and Confirmation Requirements:* If the bank effects securities transactions at the direction and for the account of customers, determine if it is in compliance with this regulation by substantiating Internal Control questions 24–35.

16. Test for unsafe and unsound practices and possible violations of the Securities Exchange Act of 1934 by:
    a. Reviewing customer account schedules of own bank and affiliated bank permanent portfolios, trusts, other broker-dealers, employees of own or other banks and other broker-dealers. Use an appropriate technique to select transactions and compare trade prices to independently established market prices as of the date of trade.
    b. Reviewing transactions, including U.S. government tender offer subscription files, involving employees and directors of own or other banks and determine if the funds used in the transactions were misused bank funds or the proceeds of reciprocal or preferential loans.
    c. Reviewing sales to affiliated companies to determine that the sold securities were not subsequently repurchased at an additional mark-up and that gains were not recognized a second time.
    d. Reviewing commercial paper sales journals or confirmations to determine if the bank sells affiliate commercial paper. If so, determine if:
       - The bank sells affiliate-issued commercial paper to institutions and financially sophisticated individuals only.
       - Sales are generally denominated in amounts of $25,000 or more.
       - Each sale confirmation discloses that the affiliate-issued commercial paper is not an insured bank deposit.
    e. Reviewing securities position records and customer ledgers with respect to large volume repetitive purchase and sales transactions and:
       - Independently testing market prices of significant transactions which involve the purchase and resale of the same security to the same or related parties.
       - Investigating the purchase of large blocks of securities from dealer firms just prior to month end and their subsequent resale to the same firm just after the beginning of the next month.
    f. Reviewing lists of approved dealer firms and determining that the approval of any firm that handles a significant volume of agency transactions is based on competitive factors rather than deposit relationships.
    g. Reviewing customer complaint files and determining the reasons for such complaints.

17. Discuss with an appropriate officer and prepare report comments concerning:
    a. The soundness of trading objectives, policies and practices.
    b. The degree of legal and market risk assumed by trading operations.
    c. The effectiveness of analytical, reporting and control systems.
    d. Violations of law.
    e. Internal control deficiencies.
    f. Apparent or potential conflicts of interest.
    g. Other matters of significance.

18. Reach a conclusion regarding the quality of department management and state your conclusions on the management brief provided by the examiner assigned "Management Assessment."

19. Update workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures regarding bank dealer activities. The bank's system should be documented in a complete, 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.

This section applies to all bank dealer activities except those involving municipal securities, which are reviewed as part of a separate and distinct Municipal Bond Dealer Examination.

SECURITIES UNDERWRITING TRADING POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written securities underwriting/trading policies that:
   a. Outline objectives?
   b. Establish limits and/or guidelines for:
      - Price mark-ups?
      - Quality of issues?
      - Maturity of issues?
      - Inventory positions (including when issued (WI) positions)?
      - Amounts of unrealized loss on inventory positions?
      - Length of time an issue will be carried in inventory?
      - Amounts of individual trades or underwriter interests?
      - Acceptability of brokers and syndicate partners?
   c. Recognize possible conflicts of interest and establish appropriate procedures regarding:
      - Deposit and service relationships with municipalities whose issues have underwriting links to the trading department?
      - Deposit relationships with securities firms handling significant volumes of agency transactions or syndicate participations?
      - Transfers made between trading account inventory and investment portfolio(s)?
      - The bank's trust department acting as trustee, paying agent, and transfer agent for issues which have an underwriting relationship with the trading department?
   d. State procedures for periodic, monthly or quarterly, valuation of trading inventories to market value or to the lower of cost or market price?
   e. State procedures for periodic independent verification of valuations of the trading inventories?
   f. Outline methods of internal review and reporting by department supervisors and internal auditors to insure compliance with established policy?
   g. Identify permissible types of securities?
   h. Ensure compliance with the rules of fair practice that:
      - Prohibit any deceptive, dishonest or unfair practice?
      - Adopt formal suitability checklists?
      - Monitor gifts and gratuities?
      - Prohibit materially false or misleading advertisements?
      - Adopt a system to determine the existence of possible control relationships?
      - Prohibit the use of confidential, non-public information without written approval of the affected parties?
      - Prohibit improper use of funds held on another's behalf?
      - Allocate responsibility for transactions with own employees and employees of other dealers?
      - Require disclosure on all new issues?
   i. Provide for exceptions to standard policy?
2. Are the underwriting/trading policies reviewed at least quarterly by the board to determine their adequacy in light of changing conditions?
3. Is there a periodic review by the board to assure that the underwriting/trading department is in compliance with its policies?

OFFSETTING RESALE AND REPURCHASE TRANSACTIONS

4. Has the board of directors, consistent with its duties and responsibilities, adopted written offsetting repurchase transaction policies that:
   a. Limit the aggregate amount of offsetting repurchase transactions?
   b. Limit the amounts in unmatched or extended (over 30 days) maturity transactions?
   c. Determine maximum time gaps for unmatched maturity transactions?
   d. Determine minimumly acceptable interest rate spreads for various maturity transactions.
   e. Determine the maximum amount of funds to be extended to any single or related firms through reverse re-po transactions, involving unsold (through forward sales) securities?
   f. Require firms involved in reverse re-po transactions to submit corporate resolutions stating the names and limits of individuals, who are authorized to commit the firm?
   g. Require submission of current financial information by firms involved in reverse re-po transactions?
   h. Provide for periodic credit reviews and approvals for firms involved in reverse re-po transactions?
   i. Specify types of acceptable offsetting repurchase transaction collateral (if so, indicate type __________).
5. Are written collateral control procedures designed so that:
   a. Collateral assignment forms are used?
   b. Collateral assignments of registered securities are accompanied by powers of attorney signed by the registered owner?
      - Registered securities are registered in bank or bank's nominee name when they are assigned as collateral for extended maturity (over 30 days) reverse re-po transactions?
   c. Funds are not disbursed until reverse re-po collateral is delivered into the physical custody of the bank or an independent safekeeping agent?
   d. Funds are only advanced against predetermined collateral margins ordiscounts?
      - If so, indicate margin or discount percentage __________.
   e. Collateral margins or discounts are predicated upon:
      - The type of security pledged as collateral?
      - Maturity of collateral?
      - Historic and anticipated price volatility of the collateral?
      - Maturity of the reverse re-po agreements?
   f. Maintenance agreements are required to support predetermined collateral margin or discount?
   g. Maintenance agreements are structured to allow margin calls in the event of collateral price declines?
   h. Collateral market value is frequently checked to determine compliance with margin and maintenance requirements (if so, indicate frequency ________)?

CUSTODY AND MOVEMENT OF SECURITIES

*6. Are the bank's procedures such that persons do not have sole custody of securities in that:
   a. They do not have sole physical access to securities?
   b. They do not prepare disposal documents that are not also approved by authorized persons?
   c. For the security custodian, supporting disposal documents are examined or adequately tested by a second custodian?
   d. No person authorizes more than one of the following transactions: execution of trades, receipt and delivery of securities, and collection or disbursement of payment?
7. Are securities physically safeguarded to prevent loss, unauthorized disposal or use? And:
   a. Are negotiable securities kept under dual control?
   b. Are securities counted frequently, on a surprise basis, reconciled to the securi-

ties record, and the results of such counts reported to management?

c. Does the bank periodically test for compliance with provisions of its insurance policies regarding custody of securities?

d. For securities in the custody of others:
   - Are custody statements agreed periodically to position ledgers and any differences followed up to a conclusion?
   - Are statements received from brokers and other dealers reconciled promptly, and any differences followed up to a conclusion?
   - Are positions for which no statements are received confirmed periodically, and stale items followed up to a conclusion?

8. Are trading account securities segregated from other bank owned securities or securities held in safekeeping for customers?

*9. Is access to the trading securities vault restricted to authorized employees?

10. Do withdrawal authorizations require countersignature to indicate security count verifications?

11. Is registered mail used for mailing securities, and are adequate receipt files maintained for such mailings (if registered mail is used for some but not all mailings, indicate criteria and reasons)?

12. Are prenumbered forms used to control securities trades, movements and payments?

13. If so, is numerical control of prenumbered forms accounted for periodically by persons independent of those activities?

14. Do alterations to forms governing the trade, movement, and payment of securities require:
   *a. Signature of the authorizing party?
   b. Use of a change of instruction form?

15. With respect to negotiability of registered securities:
   a. Are securities kept in non-negotiable form whenever possible?
   b. Are all securities received, and not immediately delivered, transferred to the name of the bank or its nominee and kept in non-negotiable form whenever possible?
   c. Are securities received checked for negotiability (endorsements, signature, guarantee, legal opinion, etc.) and for completeness (coupons, warrants, etc.) before they are placed in the vault?

RECORDS MAINTENANCE

16. Does the bank maintain:
   a. Order tickets which include:
      - Capacity as principal or agent?
      - If order is firm or conditional?
      - Terms, conditions or instructions and modifications?
      - Type of transaction (purchase or sale)?
      - Execution price?
      - Description of security?
      - Date and time of order receipt?
      - Date and time of execution?
      - Dealer's or customer's name?
      - Delivery and payment instructions?
      - Terms, conditions, date and time of cancellation of an agency order?
   b. Customer confirmations:
      - Bank dealer's name, address and phone number?
      - Customer's name?
      - Designation of whether transaction was a purchase from or sale to the customer?
      - Par value of securities?
      - Description of securities, including at a minimum:
        - — Name of issuer?
        - — Interest rate?
        - — Maturity date?
        - — Designation, if securities are subject to limited tax?
        - — Subject to redemption prior to maturity (callable)?
        - — Designation, if revenue bonds and the type of revenue?
        - — The name of any company or person in addition to the issuer who is obligated, directly or indirectly, to pay debt service on revenue bonds? (In the case of more than one such obligor, the phrase "multiple obligors" will suffice.)
        - — Dated date, if it affects price or interest calculations?
        - — First interest payment date, if other than semi-annual?

   - Designation, if securities are "fully registered" or "registered as principal"?
   - Designation, if securities are "pre-refunded"?
   - Designation, if securities have been "called," maturity date fixed by call notice and amount of call price?
   - Denominations of bearer bonds, if other than denominations of $1,000 and $5,000 par value?
   - Denominations of registered bonds, if other than multiples of $1,000 par value up to $100,000 par value?
   - Denominations of municipal notes?
- Trade date and time of execution, or a statement that time of execution will be furnished upon written request of the customer?
- Settlement date?
- Yield and dollar price? Only the dollar price need to be shown for securities traded at par.
   - For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity, and if priced to premium call or par option, a statement to that effect and the call or option date and price used in the calculation?
- Amount of accrued interest?
- Extended principal amount?
- Total dollar amount of transaction?
- The capacity in which the bank dealer effected the transaction:
   - As principal for own account?
   - As agent for customer?
   - As agent for a person other than the customer?
   - As agent for both the customer and another person (dual agent)?
- If a transaction is effected as agent for the customer or as dual agent:
   - Either the name of the contra-party or a statement that the information will be furnished upon request?
   - The source and amount of any commission or other remuneration to the bank dealer?
- Payment and delivery instructions?
- Special instructions, such as:
   - "Ex-legal" (traded without legal opinion)?
   - "Flat" (traded without interest)?
   - "In default" as to principal or interest?

c. Dealer confirmations:
- Bank dealer's name, address and telephone number?
- Contra-party identification?
- Designation of purchase from or sale to?
- Par value of securities?
- Description of securities, including at a minimum:
   - Name of issuer?
   - Interest rate?
   - Maturity date?
   - Designation, if securities are limited tax?
   - Subject to redemption prior to maturity (callable)?
   - Designation, if revenue bonds and the type of revenue?
   - Dated date, if it affects price or interest calculations?
   - First interest payment date, if other than semi-annual?
   - Designation, if securities are "fully registered" or "registered as principal"?
   - Designation, if securities are "pre-refunded"?
   - Designation, if securities have been "called," maturity date fixed by call notice and amount of call price?
   - Denominations of bearer bonds, if other than denominations of $1,000 and $5,000 par value?
   - Denominations of registered bonds, if other than multiples of $1,000 par value up to $100,000 par value?
- CUSIP number, if assigned (effective January 1, 1979)?
- Trade date?
- Settlement date?
- Yield to maturity and resulting dollar price? Only the dollar price need be

shown for securities traded at par or on a dollar basis.
  - — For transactions in callable securities effected on a yield basis, the resulting price calculated to the lowest of price to call premium, par option (callable at par) or to maturity?
  - — If applicable, the fact that securities are priced to premium call or par option and the call or option date and price used in the calculation?
- Amount of accrued interest?
- Extended principal amount?
- Total dollar amount of transaction?
- Payment and delivery instructions?
- Special instructions, such as:
  - — ‘‘Ex-legal’’ (traded without legal opinion)?
  - — ‘‘Flat’’ (traded without interest)?
  - — ‘‘In default’’ as to principal or interest?

d. Purchase and sale journals or blotters which include:
- Trade date?
- Description of securities?
- Aggregate par value?
- Unit dollar price or yield?
- Aggregate trade price?
- Accrued interest?
- Name of buyer or seller?
- Name of party received from or delivered to?
- Bond or note numbers?
- Indication if securities are in registered form?
- Receipts or disbursements of cash?
- Specific designation of ‘‘when issued’’ transactions?
- Transaction or confirmation numbers recorded in consecutive sequence to insure that transactions are not omitted?
- Other references to documents of original entry?

e. Short sale ledgers which include:
- Sale price?
- Settlement date?
- Present market value?
- Basis point spread?
- Description of collateral?
- Cost of collateral or cost to acquire collateral?
- Carrying charges?

f. Security position ledgers, showing separately for each security positioned for the bank’s own account:
- Description of the security?
- Posting date (either trade or settlement date, provided posting date is consistent with other records of original entry)?
- Aggregate par value?
- Cost?
- Average cost?
- Location?
- Count differences classified by the date on which they were discovered?

g. Securities transfer or validation ledgers which include:
- Address where securities were sent?
- Date sent?
- Description of security?
- Aggregate par value?
- If registered securities:
  - — Present name of record?
  - — New name to be registered?
- Old certificate or note numbers?
- New certificate or note numbers?
- Date returned?

h. Securities received and delivered journals or tickets which include:
- Date of receipt or delivery?
- Name of sender and receiver?
- Description of security?
- Aggregate par value?
- Trade and settlement dates?
- Certificate numbers?

i. Cash or wire transfer receipt and disbursement tickets which include:
- Draft or check numbers?
- Customer accounts debited or credited?
- Notation of the original entry item that initiated the transaction?

j. Cash or wire transfer journals which additionally include:
- Draft or check reconcilements?
- Daily totals of cash debits and credits?
- Daily proofs?

k. Fail ledgers which include:
- Description of security?
- Aggregate par value?
- Price?
- Fail date?
- Date included on fail ledger?
- Customer or dealer name?
- Resolution date?

  - A distinction between a customer and a dealer fail?
  - Follow-up detail regarding efforts to resolve the fail?

l. Securities borrowed and loaned ledgers which include:
  - Date of transaction?
  - Description of securities?
  - Aggregate par value?
  - Market value of securities?
  - Contra-party name?
  - Value at which security was loaned?
  - Date returned?
  - Description of collateral?
  - Aggregate par value of collateral?
  - Market value of collateral?
  - Collateral safekeeping location?
  - Dates of periodic valuations?

m. Records concerning written or oral put options, guarantee and repurchase agreements which include:
  - Description of the securities?
  - Aggregate par value?
  - Terms and conditions of the option, agreement or guarantee?

n. Customer account information which includes:
  - Customer's name and residence or principal business address?
  - Whether customer is of legal age?
  - Occupation?
  - Name and address of employer? And:
    — Whether customer is employed by a securities broker or dealer or by a municipal securities dealer?
  - Name and address of beneficial owner or owners of the account if other than customer? And:
    — Whether transactions are confirmed with such owner or owners?
  - Name and address of person(s) authorized to transact business for a corporate, partnership or trusteed account? And:
    — Copy of powers of attorney, resolutions or other evidence of authority to effect transactions for such an account?
  - With respect to borrowing or pledging securities held for the accounts of customers:
    — Written authorization from the customer authorizing such activities?
  - Customer complaints including:
    — Records of all written customer complaints?
    — Record of actions taken concerning those complaints?

o. Customer and the bank dealer's own account ledgers which include:
  - All purchases and sales of securities?
  - All receipts and deliveries of securities?
  - All receipts and disbursements of cash?
  - All other charges or credits?

p. Records of syndicates' joint accounts or similar accounts formed for the purchase of municipal securities which include:
  - Underwriter agreements? And:
    — Description of the security?
    — Aggregate par value of the issue?
  - Syndicate or selling group agreements? And:
    — Participants' names and percentages of interest?
    — Terms and conditions governing the formation and operation of the syndicate?
    — Date of closing of the syndicate account?
    — Reconcilement of syndicate profits and expenses?
  - Additional requirements for syndicate or underwriting managers which include:
    — All orders received for the purchase of securities from the syndicate or account, except bids at other than the syndicate price?
    — All allotments of securities and the price at which sold?
    — Date of settlement with the issuer?
    — Date and amount of any good faith deposit made with the issuer?

q. Files which include:
  - Advertising and sales literature
  - Prospectus delivery information?

r. Internal supervisory records which include:
  - Account reconcilement and follow-up?
  - Profit analysis by trader?
  - Sales production reports?

- Periodic open position reports computed on a trade date or when issued basis?
- Reports of own bank credit extensions used to finance the sale of trading account securities?

PURCHASE AND SALES TRANSACTIONS

17. Are all transactions promptly confirmed in writing to the actual customers or dealers?
18. Are confirmations compared or adequately tested to purchase and sales memoranda and reports of execution of orders, and any differences investigated and corrected (including approval by a designated responsible employee)?
    a. Are confirmations and purchase and sale memoranda checked or adequately tested for computation and terms by a second individual?
19. Are comparisons received from other dealers or brokers compared with confirmations, and any differences promptly investigated?
    a. Are comparisons approved by a designated individual (if so, give name __________)?

CUSTOMER AND DEALER ACCOUNTS

20. Do account bookkeepers periodically transfer to different account sections or otherwise rotate posting assignments?
21. Are letters mailed to customers requesting confirmation of changes of address?
22. Are separate customer account ledgers maintained for:
    - Employees?
    - Affiliates?
    - Own bank's trust accounts?
23. Are customer inquiries and complaints handled exclusively by designated individuals who have no incompatible duties?

RECORDKEEPING AND CONFIRMATION REQUIREMENTS FOR CUSTOMER SECURITIES TRANSACTIONS (REGULATION H)

24. Are chronological records of original entry containing an itemized daily record of all purchases and sales of securities maintained?
25. Do the original entry records reflect:
    a. The account or customer for which each such transaction was effected?
    b. The description of the securities?
    c. The unit and aggregate purchase or sale price (if any)?
    d. The trade date?
    e. The name or other designation of the broker-dealer or other person from whom purchased or to whom sold?

If the bank has had an average of 200 or more securities transactions per year for customers over the prior three-calendar-year period, exclusive of transactions in U.S. government and federal agency obligations, answer questions 26, 27 and 28.

26. Does the bank maintain account records for each customer which reflect:
    a. All purchases and sales of securities?
    b. All receipts and deliveries of securities?
    c. All receipts and disbursements of cash for transactions in securities for such account?
    d. All other debits and credits pertaining to transactions in securities?
27. Does the bank maintain a separate memorandum (order ticket) of each order to purchase or sell securities (whether executed or cancelled) which includes:
    a. The account(s) for which the transaction was effected?
    b. Whether the transaction was a market order, limit order, or subject to special instructions?
    c. The time the order was received by the trader or other bank employee responsible for affecting the transaction?
    d. The time the order was placed with the broker-dealer, or if there was no broker-dealer, the time the order was executed or cancelled?
    e. The price at which the order was executed?

f. The broker-dealer used?

28. Does the bank maintain a record of all broker-dealers selected by the bank to effect securities transactions and the amount of commissions paid or allocated to each such broker during the calendar year?
29. Does the bank, subsequent to effecting a securities transaction for a customer, mail or otherwise furnish to such customer either a copy of the confirmation of a broker-dealer relating to the securities transaction or a written trade confirmation of a broker-dealer relating to the securities transaction or a written trade confirmation prepared by the bank?
30. If customer notification is provided by furnishing the customer with a copy of the confirmation of a broker-dealer relating to the transaction, and if the bank is to receive remuneration from the customer or any other source in connection with the transaction, and the remuneration is not determined pursuant to a written agreement between the bank and the customer, does the bank also provide a statement of the source and amount of any remuneration to be received?
31. If customer notification is provided by furnishing the customer with a trade confirmation prepared by the bank, does the confirmation disclose:
    a. The name of the bank?
    b. The name of the customer?
    c. Whether the bank is acting as agent for such customer, as principal for its own account, or in any other capacity?
    d. The date of execution and a statement that the time of execution will be furnished within a reasonable time upon written request of such customer?
    e. The identity, price and number of shares of units (or principal amount in the case of debt securities) of such securities purchased or sold by such customer?
32. For transactions which the bank effects in the capacity of agent, does the bank, in addition to the above, disclose:
    a. The amount of any remuneration received or to be received, directly or indirectly, by any broker-dealer from such customer in connection with the transaction?
    b. The amount of any remuneration received or to be received by the bank from the customer and the source and amount of any other remuneration to be received by the bank in connection with the transaction, unless remuneration is determined pursuant to a written agreement between the bank and the customer?
    c. The name of the broker-dealer used. Where there is no broker-dealer, the name of the person from whom the security was purchased or to whom it was sold, or the fact that such information will be furnished within a reasonable time upon written request?
33. Does the bank maintain the above records and evidence of proper notification for a period of at least three years?
34. Does the bank furnish the written notification described above within five business days from the date of the transaction, or if a broker-dealer is used, within five business days from the receipt by the bank of the broker-dealer's confirmation? If not, does the bank use one of the alternative procedures described in Regulation H?
35. Unless specifically exempted in Regulation H, does the bank have established written policies and procedures ensuring:
    a. That bank officers and employees who make investment recommendations or decisions for the accounts of customers, who particpate in the determination of such recommendations or decisions, or who, in connection with their duties, obtain information concerning which securities are being purchased or sold or recommended for such action, report to the bank, within 10 days after the end of the calendar quarter, all transactions in securities made by them or on their behalf, either at the bank or elsewhere in which they have a beneficial interest (subject to certain exemptions)?
    b. That in the above required report the bank officers and employees identify the securities purchased or sold and indicate the dates of the transactions and whether the transactions were purchases or sales?
    c. The assignment of responsibility for supervision of all officers or employees who (1) transmit orders to or place orders with broker-dealers, or (2) execute transactions in securities for customers?

d. The fair and equitable allocation of securities and prices to accounts when orders for the same security are received at approximately the same time and are placed for execution either individually or in combination?
e. Where applicable, and where permissible under local law, the crossing of buy and sell orders on a fair and equitable basis to the parties to the transaction?

OTHER

36. Are the preparation, additions, and posting of subsidiary records performed and/or adequately reviewed by persons who do not also have sole custody of securities?
37. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items adequately investigated by persons who do not also have sole custody of securities?
38. Are fails to receive and deliver under a separate general ledger control?
    a. Are fail accounts periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    b. Are periodic aging schedules prepared (if so, indicate frequency __________)?
    c. Are stale fail items confirmed and followed up to a conclusion?
    d. Are stale items valued periodically and, if any potential loss is indicated, is a particular effort made to clear such items or to protect the bank from loss by other means?
39. With respect to securities loaned and borrowed positions:
    a. Are details periodically reconciled to the general ledger, and any differences followed up to a conclusion?
    b. Are positions confirmed periodically (if so, indicate frequency ___________)?
40. Is the compensation of all department employees limited to salary and a nondepartmentalized bonus or incentive plan?
    a. Are sales representatives' incentive programs based on sales volume and not department income?

CONCLUSION

41. 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.
42. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

Banking organizations increasingly rely on information technology (IT) to conduct their operations and manage risks. The use of IT can have important implications for a banking organization's financial condition, risk profile, and operating performance and should be incorporated into the safety-and-soundness assessment of each organization. As a result, all safety-and-soundness examinations (or examination cycles) conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. Further information about banks' IT activities and examination methodology can be found in the *FFIEC Information Technology Examination Handbook* (the *IT Handbook*) and in supervisory guidance issued by the Federal Reserve and the other federal banking agencies.

ASSESSING INFORMATION TECHNOLOGY IN THE RISK-FOCUSED SUPERVISORY FRAMEWORK

The risk-focused supervisory process is evolving to adapt to the changing role of IT in banking organizations, with greater emphasis on an assessment of IT's effect on an organization's safety and soundness. Accordingly, examiners should explicitly consider IT when developing risk assessments and supervisory plans. Examiners should use appropriate judgment in determining the level of review, given the characteristics, size, and business activities of the organization. Moreover, to determine the scope of supervisory activities, close coordination is needed between general safety-and-soundness examiners and IT specialists during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of IT environments, the level of technical expertise needed for a particular examination will vary across institutions and should be identified during the planning phase of the examination. In general, examiners should accomplish the following goals during a risk-focused examination:

- Develop a broad understanding of the organization's approach to, and strategy and structure for, IT activities within and across business lines. Determine also the role and importance of IT to the organization and any unique characteristics or issues.
- Incorporate an analysis of IT activities into risk assessments, supervisory plans, and scope memoranda. An organization's IT systems should be considered in relation to the size, activities, and complexity of the organization, as well as the degree of reliance on these systems across particular business lines. Although IT concerns would clearly affect an institution's operational risk profile, IT also can affect other business risks (such as credit, market, liquidity, legal, and reputational risk), depending upon the specific circumstances, and should be incorporated into these assessments as appropriate.
- Assess the organization's critical systems, that is, those that support its major business activities, and the degree of reliance those activities have on IT systems. The level of review should be sufficient to determine that the systems are delivering the services necessary for the organization to conduct its business in a safe and sound manner.
- Determine whether senior management is adequately identifying, measuring, monitoring, and controlling the significant risks associated with IT for the overall organization and its major business activities.

INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

The federal banking agencies jointly issued interagency guidelines establishing information security standards (the information security standards), which became effective July 1, 2001.[1] (See the appendix to this section.) The Board of Governors of the Federal Reserve System approved amendments to the standards on December 16, 2004 (effective July 1, 2005). The amended information security standards implement sections 501 and 505 of the Gramm-Leach-Bliley Act (15 U.S.C. 6801 and 6805) and section 216 of the Fair and Accurate Credit Transactions Act of 2003 (15 U.S.C. 1681w).

1. See 66 Fed. Reg. 8616–8641 (February 1, 2001) and 69 Fed. Reg. 77,610–77,612 (December 28, 2004); Regulation H, 12 CFR 208, appendix D-2; Regulation K, 12 CFR 211.9 and 211.24; and Regulation Y, 12 CFR 225, appendix F.

The Gramm-Leach-Bliley Act requires the agencies to establish financial-institution information security standards for administrative, technical, and physical safeguards for customer records and information. (See SR-01-15.)

Under the information security standards, institutions must establish an effective *written* information security program to assess and control risks to customer information. An institution's information security program should be appropriate to its size and complexity and to the nature and scope of its operations. The board of directors should oversee the institution's development, implementation, and maintenance of the information security program and also approve written information security policies and programs.

The information security program should include administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. The program should be designed to ensure the security and confidentiality of customer information;[2] protect against anticipated threats or hazards to the security or integrity of such information; protect against unauthorized access to, or use of, such information that could result in substantial harm or inconvenience to any customer;[3] and ensure the proper disposal of customer information and consumer information. Each institution must assess risks to customer information and implement appropriate policies, procedures, training, and testing to manage and control these risks. Institutions must also report annually to the board of directors or a committee of the board of directors.

The information security standards outline specific security measures that banking organizations should consider in implementing a security program based on the size and complexity of their operations. Training and testing are also critical components of an effective information security program. Financial institutions are required to oversee their service-provider arrangements in order to (1) protect the security of customer information maintained or processed by service providers; (2) ensure that its service providers properly dispose of customer and consumer information; and (3) where warranted, monitor its service providers to confirm that they have satisfied their contractual obligations.

The Federal Reserve recognizes that banking organizations are highly sensitive to the importance of safeguarding customer information and the need to maintain effective information security programs. Existing examination procedures and supervisory processes already address information security. As a result, most banking organizations may not need to implement any new controls and procedures.

Examiners should assess compliance with the standards during each safety-and-soundness examination, which may include targeted reviews of information technology. Ongoing compliance with the standards should be monitored, as needed, during the risk-focused examination process. Material instances of noncompliance should be noted in the examination report.

The information security standards apply to customer information maintained by, or on behalf of, state member banks and bank holding companies and the nonbank subsidiaries of each.[4] The information security standards also address standards for the proper disposal of consumer information, pursuant to sections 621 and 628 of the Fair Credit Reporting Act (15 U.S.C. 1681s and 1681w). To address the risks associated with identity theft, a financial institution is generally required to develop, implement, and maintain, as part of its existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports.

Consumer information is defined as any record about an individual, whether in paper, electronic, or other form, that is a consumer report or is derived from a consumer report and that is maintained or otherwise possessed by or on behalf of the bank for a business purpose.

2. *Customer information* is defined to include any record, whether in paper, electronic, or other form, containing *nonpublic personal information*, as defined in Regulation P, about a financial institution's customer that is maintained by, or on behalf of, the institution.

3. A *customer* is defined in the same manner as in Regulation P: a consumer who has established a continuing relationship with an institution under which the institution provides one or more financial products or services to the consumer to be used primarily for personal, family, or household purposes. The definition of customer does not include a business, nor does it include a consumer who has not established an ongoing relationship with the financial institution.

4. The information security standards do not apply to brokers, dealers, investment companies, and investment advisers, or to persons providing insurance under the applicable state insurance authority of the state in which the person is domiciled. The appropriate federal agency or state insurance authority regulates insurance entities under sections 501 and 505 of the GLB Act.

Consumer information also means a compilation of such records.

The following are examples of consumer information:

- a consumer report that a bank obtains
- information from a consumer report that the bank obtains from its affiliate after the consumer has been given a notice and has elected not to opt out of that sharing
- information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
- information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
- information from a consumer report that the bank obtains about an employee or prospective employee

Consumer information does not include any record that does not personally identify an individual, nor does it include the following:

- aggregate information, such as the mean score, derived from a group of consumer reports
- blind data, such as payment history on accounts that are not personally identifiable, that may be used for developing credit scoring-models or for other purposes
- information from a consumer report that the bank obtains about an individual who applies for but does not receive a loan, including any loan sought by an individual for a business purpose
- information from a consumer report that the bank obtains about an individual who guarantees a loan (including a loan to a business entity)
- information from a consumer report that the bank obtains about an employee or prospective employee

An institution or banking organization is not required to implement a *uniform* information security program. For example, a bank holding company may include subsidiaries within the scope of its information security program, or the subsidiaries may implement separate information security programs. The institution or bank holding company is expected, however, to coordinate all the elements of its information security program.

Institutions must exercise due diligence when selecting service providers, including reviewing the service provider's information security program or the measures the service provider uses to protect the institution's customer information.[5] All contracts must require that the service provider implement appropriate measures designed to meet the objectives of the standards. Institutions must also conduct ongoing oversight to confirm that the service provider maintains appropriate security measures. An institution's methods for overseeing its service-provider arrangements may differ depending on the type of services or service provider or the level of risk. For example, if a service provider is subject to regulations or a code of conduct that imposes a duty to protect customer information consistent with the objectives of the standards, the institution may consider that duty in exercising its due diligence and oversight of the service provider. In situations where a service provider hires a subservicer (or subcontractor), the subservicer would not be considered a "service provider" under the guidelines.

Response Programs for Unauthorized Access to Customer Information and Customer Notice

Response programs specify actions that are to be taken when a financial institution suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies.[6] A response program is the principal means for a financial institution to protect against unauthorized "use" of customer information that could lead to "substantial harm or inconvenience" to the institution's customer. For example, customer notification is an important tool that enables a customer to take steps to prevent identity theft, such as by arranging to have a fraud alert placed in his or her credit file.

The measures enumerated in the information security standards include "response programs

5. A *service provider* is deemed to be a person or entity that maintains, processes, or is otherwise permitted access to customer information through its provision of services directly to the bank.

6. See the information security standards, 12 CFR 208, appendix D-2, section III.C.

that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies."[7] Prompt action by both the institution and the customer following the unauthorized access to customer information is crucial to limiting identity theft. As a result, every financial institution should develop and implement a response program appropriate to its size and complexity and to the nature and scope of its activities. The program should be designed to address incidents of unauthorized access to customer information.

The Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice[8] (the guidance) interprets section 501(b) of the Gramm-Leach-Bliley Act (the GLB Act) and the information security standards.[9] The guidance describes the response programs, including customer notification procedures, that a financial institution should develop and implement to address unauthorized access to or use of customer information that could result in substantial harm or inconvenience to a customer.

When evaluating the adequacy of an institution's information security program that is required by the information security standards, examiners are to consider whether the institution has developed and implemented a response program equivalent to the guidance. At a minimum, an institution's response program should contain procedures for (1) assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused; (2) notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined later in the guidance; (3) immediately notifying law enforcement in situations involving federal criminal violations requiring immediate attention; (4) taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, such as by monitoring, freezing, or closing affected accounts, while preserving records and other evidence; and (5) notifying customers when warranted.

The guidance does not apply to a financial institution's foreign offices, branches, or affiliates. However, a financial institution subject to the information security standards is responsible for the security of its customer information, whether the information is maintained within or outside of the United States, such as by a service provider located outside of the United States.

The guidance also applies to *customer information,* meaning any record containing "nonpublic personal information" about a financial institution's customer, whether the information is maintained in paper, electronic, or other form, *that is maintained by or on behalf of the institution.*[10] (See the Board's privacy rule, Regulation P, at section 216.3(n)(2) (12 CFR 216.3 (n)(2).) Consequently, the guidance applies only to information that is within the control of the institution and its service providers. The guidance would not apply to information directly disclosed by a customer to a third party, for example, through a fraudulent web site.

The guidance also does not apply to information involving business or commercial accounts. Instead, the guidance applies to nonpublic personal information about a *customer,* as that term is used in the information security standards, namely, a consumer who obtains a financial product or service from a financial institution to be used primarily for personal, family, or household purposes and who has a continuing relationship with the institution.[11]

Response Programs

Financial institutions should take preventative measures to safeguard customer information against attempts to gain unauthorized access to the information. For example, financial institutions should place access controls on customer information systems and conduct background checks for employees who are authorized to

7. See the information security standards, section III.C.1.g.

8. The guidance was jointly issued on March 23, 2005 (effective March 29, 2005), by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

9. See 12 CFR 208, appendix D-2, and 12 CFR 225, appendix F. The Interagency Guidelines Establishing Information Security Standards were formerly known as the Interagency Guidelines Establishing Standards for Safeguarding Customer Information.

10. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.e.

11. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.d., and the Board's privacy rule (Regulation P), section 216.3(h) (12 CFR 216.3(h)).

access customer information.[12] However, every financial institution should also develop and implement a risk-based response program to address incidents of unauthorized access to customer information in customer information systems[13] that occur nonetheless. A response program should be a key part of an institution's information security program.[14] The program should be appropriate to the size and complexity of the institution and the nature and scope of its activities.

In addition, each institution should be able to address incidents of unauthorized access to customer information in customer information systems maintained by its domestic and foreign service providers. Therefore, consistent with the obligations in the information security standards that relate to these arrangements, and with existing guidance on this topic issued by the agencies,[15] an institution's contract with its service provider should require the service provider to take appropriate actions to address incidents of unauthorized access to the financial institution's customer information, including notification to the institution as soon as possible of any such incident, to enable the institution to expeditiously implement its response program.

Components of a response program. At a minimum, an institution's response program should contain procedures for the following:

- assessing the nature and scope of an incident, and identifying what customer information systems and types of customer information have been accessed or misused
- notifying its primary federal regulator as soon as possible when the institution becomes aware of an incident involving unauthorized access to or use of *sensitive* customer information, as defined below
- consistent with the Suspicious Activity Report regulations,[16] notifying appropriate law enforcement authorities, in addition to filing a timely SAR in situations involving federal criminal violations requiring immediate attention, such as when a reportable violation is ongoing
- taking appropriate steps to contain and control the incident to prevent further unauthorized access to or use of customer information, for example, by monitoring, freezing, or closing affected accounts, while preserving records and other evidence
- notifying customers when warranted

Where an incident of unauthorized access to customer information involves customer information systems maintained by an institution's service providers, it is the responsibility of the financial institution to notify the institution's customers and regulator. However, an institution may authorize or contract with its service provider to notify the institution's customers or regulator on its behalf.

Customer Notice

Financial institutions have an affirmative duty to protect their customers' information against unauthorized access or use. Notifying customers of a security incident involving the unauthorized access or use of the customer's information in accordance with the standard set forth below is a key part of that duty. Timely notification of customers is important to managing an institution's reputation risk. Effective notice also may reduce an institution's legal risk, assist in maintaining good customer relations, and enable the institution's customers to take steps to protect themselves against the consequences of identity theft. When customer notification is warranted, an institution may not forgo notifying its customers of an incident because the institution believes that it may be potentially embarrassed or inconvenienced by doing so.

12. Institutions should also conduct background checks of employees to ensure that the institution does not violate 12 U.S.C. 1829, which prohibits an institution from hiring an individual convicted of certain criminal offenses or who is subject to a prohibition order under 12 U.S.C. 1818(e)(6).

13. Under the information security standards, an institution's *customer information systems* consist of all the methods used to access, collect, store, use, transmit, protect, or dispose of customer information, including the systems maintained by its service providers. See the information security standards, 12 CFR 208, appendix D-2, section I.C.2.f.

14. Reserved footnote.

15. See SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management."

16. An institution's obligation to file a SAR is set out in regulations and supervisory guidance. See 12 CFR 208.62 (state member banks); 12 CFR 211.5(k) (Edge and agreement corporations); 12 CFR 211.24(f) (uninsured state branches and agencies of foreign banks); and 12 CFR 225.4(f) (bank holding companies and their nonbank subsidiaries). See the FFIEC BSA/AML Examination Manual and also SR-01-11, "Identity Theft and Pretext Calling."

Standard for providing notice. When a financial institution becomes aware of an incident of unauthorized access to sensitive customer information, the institution should conduct a reasonable investigation to promptly determine the likelihood that the information has been or will be misused. If the institution determines that misuse of its information about a customer has occurred or is reasonably possible, it should notify the affected customer as soon as possible. Customer notice may be delayed if an appropriate law enforcement agency determines that notification will interfere with a criminal investigation and provides the institution with a written request for the delay. However, the institution should notify its customers as soon as notification will no longer interfere with the investigation.

Sensitive customer information. Under the information security standards, an institution must protect against unauthorized access to or use of customer information that could result in substantial harm or inconvenience to any customer. Substantial harm or inconvenience is most likely to result from improper access to *sensitive customer information* because this type of information is most likely to be misused, as in the commission of identity theft. For purposes of the guidance, *sensitive customer information* means a customer's name, address, or telephone number, in conjunction with the customer's Social Security number, driver's license number, account number, credit or debit card number, or a personal identification number or password that would permit access to the customer's account. Sensitive customer information also includes any combination of components of customer information that would allow someone to log onto or access the customer's account, such as a user name and password or a password and an account number.

Affected customers. If a financial institution, on the basis of its investigation, can determine from its logs or other data precisely which customers' information has been improperly accessed, it may limit notification to those customers for whom the institution determines that misuse of their information has occurred or is reasonably possible. However, there may be situations in which the institution determines that a group of files has been accessed improperly but is unable to identify which specific customers' information has been accessed. If the circumstances of the unauthorized access lead the institution to determine that misuse of the information is reasonably possible, it should notify all customers in the group.

Content of customer notice. Customer notice should be given in a clear and conspicuous manner. The notice should describe the incident in general terms and the type of customer information that was the subject of unauthorized access or use. It should also generally describe what the institution has done to protect the customers' information from further unauthorized access. In addition, it should include a telephone number that customers can call for further information and assistance.[17] The notice also should remind customers of the need to remain vigilant over the next 12 to 24 months, and to promptly report incidents of suspected identity theft to the institution. The notice should include the following additional items, when appropriate:

- a recommendation that the customer review account statements and immediately report any suspicious activity to the institution
- a description of fraud alerts and an explanation of how the customer may place a fraud alert in the customer's consumer reports to put the customer's creditors on notice that the customer may be a victim of fraud
- a recommendation that the customer periodically obtain credit reports from each nationwide credit reporting agency and have information relating to fraudulent transactions deleted
- an explanation of how the customer may obtain a credit report free of charge
- information about the availability of the FTC's online guidance regarding steps a consumer can take to protect against identity theft (The notice should encourage the customer to report any incidents of identity theft to the FTC and should provide the FTC's web site address and toll-free telephone number that customers may use to obtain the identity theft guidance and to report suspected incidents of identity theft.[18]

17. The institution should, therefore, ensure that it has reasonable policies and procedures in place, including trained personnel, to respond appropriately to customer inquiries and requests for assistance.

18. See the FTC's website for more information.

Financial institutions are encouraged to notify the nationwide consumer reporting agencies before sending notices to a large number of customers when those notices include contact information for the reporting agencies.

Delivery of customer notice. Customer notice should be delivered in any manner designed to ensure that a customer can reasonably be expected to receive it. For example, the institution may choose to contact all affected customers by telephone, by mail, or by electronic mail, in the case of customers for whom it has a valid e-mail address and who have agreed to receive communications electronically.

IDENTITY THEFT RED FLAGS PROGRAM

The federal financial institution regulatory agencies[19] and the Federal Trade Commission (FTC) have issued joint regulations and guidelines on the *detection, prevention,* and *mitigation* of identity theft in connection with opening of certain accounts or maintaining certain existing accounts in response to the Fair and Accurate Credit Transactions Act of 2003 (The FACT Act).[20] The regulations require (debit and credit) card issuers to validate notifications of changes of address under certain circumstances. The joint rules also provide guidelines regarding reasonable policies and procedures that a user of consumer reports must employ when a consumer reporting agency sends the user a notice of address discrepancy. Financial institutions or creditors[21] that offer or maintain one or more "covered accounts" must develop and implement a written Identity Theft Prevention Program (Program).[22] A Program is to be designed to detect, prevent, and mitigate identity theft in connection with the opening of a covered account or any existing covered account. The Program must be tailored to the entity's size, complexity, and the nature and scope of its operations and activities. For more information, see section 6068, "Regulation V: Fair Credit Reporting (Identity Theft Red Flags)."

IT EXAMINATION FREQUENCY AND SCOPE

All safety-and-soundness examinations (or examination cycles) of banking organizations conducted by the Federal Reserve should include an assessment and evaluation of IT risks and risk management. The scope of the IT assessment should generally be sufficient to assign a composite rating under the Uniform Rating System for Information Technology (URSIT). URSIT component ratings may be updated at the examiner's discretion, based on the scope of the assessment. The scope would normally be based on factors such as—

- implementation of new systems or technologies since the last examination;
- significant changes in operations, such as mergers or systems conversions;
- new or modified outsourcing relationships for critical operations;
- targeted examinations of business lines whose internal controls or risk-management systems depend heavily on IT; and
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues.

Institutions that outsource core processing functions, although not traditionally subject to IT examinations, are exposed to IT-related risks. For these institutions, some or all components of the URSIT rating may not be meaningful. In these cases, the assessment of IT activities may be incorporated directly into the safety-and soundness rating for the institution, rather than through the assignment of an URSIT rating. The scope of the IT assessment for such institutions should evaluate the adequacy of the institution's oversight of service providers for critical processing

19. The Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA).

20. Section 111 of the FACT Act defines "identity theft" as "a fraud committed or attempted using the identifying information of another person."

21. The term financial institution should be interpreted to mean a "financial institution or creditors" with regard to the Red Flags Program joint regulations and the accompanying interagency guidance.

22. "Covered accounts" are (1) accounts that a financial institution offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions and (2) any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft.

activities and should incorporate the results of any relevant supervisory reviews of these service providers. The assessment should also include reviews of any significant in-house activities, such as management information systems and local networks, and the implementation of new technologies, such as Internet banking. As noted above, the assessment of IT should be reflected in the overall safety-and- soundness examination report and in the appropriate components of the safety-and-soundness examination rating assigned to the institution, as well as in the associated risk-profile analysis. (See SR-00-3.)

Targeted IT examinations may be conducted more frequently, if deemed necessary, by the Reserve Bank. A composite URSIT rating should be assigned for targeted reviews when possible. In addition, institutions for which supervisory concerns have been raised (normally those rated URSIT 3, 4, or 5) should be subject to more frequent IT reviews, until such time as the Reserve Bank is satisfied that the deficiencies have been corrected.

RISK ELEMENTS

To provide a common terminology and consistent approach for evaluating the adequacy of an organization's IT, five IT elements are defined below. These elements may be used to evaluate the IT processes at the functional business level or for the organization as a whole and to determine the impact on the business risks outlined in SR-95-51 and SR-16-11, as well as their impact on the IT rating (URSIT) discussed below. (See SR-98-9.)

1. *Management processes.* Management processes encompass planning, investment, development, execution, and staffing of IT from a corporate-wide and business-specific perspective. Management processes over IT are effective when they are adequately and appropriately aligned with and support the organization's mission and business objectives. Management processes include strategic planning; budgeting; management and reporting hierarchy; management succession; and a regular, independent review function. Examiners should determine if the IT strategy for the business activity or organization is consistent with the organization's mission and business objectives and whether the IT function has effective management processes to execute that strategy.
2. *Architecture.* Architecture refers to the underlying design of an automated information system and its individual components. The underlying design encompasses both physical and logical architecture, including operating environments, as well as the organization of data. The individual components refer to network communications, hardware, and software, which includes operating systems, communications software, database-management systems, programming languages, and desktop software. Effective architecture meets current and long-term organizational objectives, addresses capacity requirements to ensure that systems allow users to easily enter data at both normal and peak processing times, and provides satisfactory solutions to problems that arise when information is stored and processed in two or more systems that cannot be connected electronically. When assessing the adequacy of IT architecture, examiners should consider the ability of the current infrastructure to meet operating objectives, including the effective integration of systems and sources of data.
3. *Integrity.* Integrity refers to the reliability, accuracy, and completeness of information delivered to the end-user. Integrity risk could arise from insufficient controls over systems or data, which could adversely affect critical financial and customer information. Examiners should review and consider whether the organization relies on information system audits or independent reviews of applications to ensure the integrity of its systems. Examiners should review the reliability, accuracy, and completeness of information delivered in key business lines.
4. *Security.* Security risk is the risk of unauthorized disclosure or destruction of critical or sensitive information. To mitigate this risk, physical access and logical controls are generally provided to achieve a level of protection commensurate with the value of the information. Security risk is managed effectively when controls prevent unauthorized access, modification, destruction, or disclosure of sensitive information during creation, transmission, processing, maintenance, or storage. Examiners should ensure that operating procedures and controls are commensurate with the potential for and risks asso-

ciated with security breaches, which may be either physical or electronic, inadvertent or intentional, internal or external.

5. *Availability.* Availability refers to the timely delivery of information and processes to end-users in support of business and decision-making processes and customer services. In assessing the management of availability risk, examiners should consider the capability of IT functions to provide information to the end-users from either primary or secondary sources, as well as consider the ability of back-up systems, as presented in contingency plans, to mitigate business disruption. Contingency plans should set out a process for an organization to restore or replace its information-processing resources; reconstruct its information assets; and resume its business activity from disruption caused by human error or intervention, natural disaster, or infrastructure failure (including loss of utilities and communication lines and the operational failure of hardware, software, and network communications).

UNIFORM RATING SYSTEM FOR INFORMATION TECHNOLOGY

The Uniform Rating System for Information Technology (URSIT) is an interagency examination rating system adopted by the Federal Financial Institutions Examination Council (FFIEC) agencies to evaluate the IT activities of financial institutions. The rating system includes component—and composite-rating descriptions and the explicit identification of risks and assessment factors that examiners consider in assigning component ratings. This rating system helps examiners assess risk and compile examination findings. However, the rating system should not drive the scope of an examination. In particular, not all assessment factors or component-rating areas are required to be assessed at each examination. Examiners should use the rating system to help evaluate the entity's overall risk exposure and risk-management performance and to determine the degree of supervisory attention believed necessary to ensure that weaknesses are addressed and that risk is properly managed. (See SR-99-8.)

The URSIT rating framework is based on a risk evaluation of four general areas: audit, management, development and acquisition, and support and delivery. These components are used to assess the overall IT functions within an organization and arrive at a composite URSIT rating. Examiners evaluate the areas identified within each component to assess the institution's ability to identify, measure, monitor, and control IT risks.

In adopting the URSIT rating system, the FFIEC recognized that management practices vary considerably among financial institutions depending on their size and sophistication, the nature and complexity of their business activities, and their risk profile. For less complex information systems environments, detailed or highly formalized systems and controls are not required to receive the higher composite and component ratings.

URSIT Composite-Rating Definitions

Financial institutions rated URSIT composite 1 exhibit strong performance in every respect and generally have components rated 1 or 2. Weaknesses in IT functions are minor and are easily corrected during the normal course of business. Risk-management processes provide a comprehensive program to identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are well defined and fully integrated throughout the organization. This allows management to quickly adapt to the changing market, business, and technology needs of the entity. Management identifies weaknesses promptly and takes appropriate corrective action to resolve audit and regulatory concerns.

Financial institutions rated URSIT composite 2 exhibit safe and sound performance but may demonstrate modest weaknesses in operating performance, monitoring, management processes, or system development. Generally, senior management corrects weaknesses in the normal course of business. Risk-management processes adequately identify and monitor risk relative to the size, complexity, and risk profile of the entity. Strategic plans are defined but may require clarification, better coordination, or improved communication throughout the organization. As a result, management anticipates, but responds less quickly to changes in the market, business, and technological needs of the entity. Management normally identifies weaknesses and takes appropriate corrective action. However, greater reliance is placed on audit and regulatory intervention to identify and resolve concerns. While internal control weaknesses may exist, there are no significant supervisory concerns. As a result, supervisory action is informal and limited.

Financial institutions rated URSIT composite 3 exhibit some degree of supervisory concern due to a combination of weaknesses that may range from moderate to severe. If weaknesses persist, further deterioration in the condition and performance of the institution is likely. Risk-management processes may not effectively identify risks and may not be appropriate for the size, complexity, or risk profile of the entity. Strategic plans are vaguely defined and may not provide adequate direction for IT initiatives. As a result, management often has difficulty responding to changes in the business, market, and technological needs of the entity. Self-assessment practices are weak and generally reactive to audit and regulatory exceptions. Repeat concerns may exist, indicating that management may lack the ability or willingness to resolve concerns. While financial or operational failure is unlikely, increased supervision is necessary. Formal or informal supervisory action may be necessary to secure corrective action.

Financial institutions rated URSIT composite 4 operate in an unsafe and unsound environment that may impair the future viability of the entity. Operating weaknesses are indicative of serious managerial deficiencies. Risk-management processes inadequately identify and monitor risk, and practices are not appropriate given the size, complexity, and risk profile of the entity. Strategic plans are poorly defined and not coordinated or communicated throughout the organization. As a result, management and the board are not committed to, or may be incapable of, ensuring that technological needs are met. Management does not perform self-assessments and demonstrates an inability or unwillingness to correct audit and regulatory concerns. Failure of the financial institution may be likely unless IT problems are remedied. Close supervisory attention is necessary and, in most cases, formal enforcement action is warranted.

Financial institutions rated URSIT composite 5 exhibit critically deficient operating performance and are in need of immediate remedial action. Operational problems and serious weaknesses may exist throughout the organization. Risk-management processes are severely deficient and provide management little or no perception of risk relative to the size, complexity, and risk profile of the entity. Strategic plans do not exist or are ineffective, and management and the board provide little or no direction for IT initiatives. As a result, management is unaware of or inattentive to the technological needs of the entity. Management is unwilling or incapable of correcting audit and regulatory concerns. Ongoing supervisory attention is necessary.

URSIT Component Ratings

Audit

Financial institutions and service providers are expected to provide independent assessments of their exposure to risks and of the quality of internal controls associated with the acquisition, implementation, and use of IT. Audit practices should address the IT risk exposures throughout the institution and the exposures of its service provider(s) in the areas of user and data center operations, client/server architecture, local and wide area networks, telecommunications, information security, electronic data interchange, systems development, and contingency planning. This rating should reflect the adequacy of the organization's overall IT audit program, including the internal and external auditor's abilities to detect and report significant risks to management and the board of directors on a timely basis. It should also reflect the internal and external auditor's capability to promote a safe, sound, and effective operation. The performance of an audit is rated based on an assessment of factors such as—

- the level of independence maintained by audit and the quality of the oversight and support provided by the board of directors and management;
- the adequacy of audit's risk-analysis methodology used to prioritize the allocation of audit resources and to formulate the audit schedule;
- the scope, frequency, accuracy, and timeliness of internal and external audit reports;
- the extent of audit participation in application development, acquisition, and testing, to ensure the effectiveness of internal controls and audit trails;
- the adequacy of the overall audit plan in providing appropriate coverage of IT risks;

- the auditor's adherence to codes of ethics and professional audit standards;
- the qualifications of the auditor, staff succession, and continued development through training;
- the existence of timely and formal follow-up and reporting on management's resolution of identified problems or weaknesses; and
- the quality and effectiveness of internal and external audit activity as it relates to IT controls.

A rating of 1 indicates strong audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or its audit committee in a thorough and timely manner. Outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities with appropriate scope and frequency. Audit work is performed in accordance with professional auditing standards, and report content is timely, constructive, accurate, and complete. Because audit is strong, examiners may place substantial reliance on audit results.

A rating of 2 indicates satisfactory audit performance. Audit independently identifies and reports weaknesses and risks to the board of directors or audit committee, but reports may be less timely. Significant outstanding audit issues are monitored until resolved. Risk analysis ensures that audit plans address all significant IT operations, procurement, and development activities; however, minor concerns may be noted with the scope or frequency. Audit work is performed in accordance with professional auditing standards; however, minor or infrequent problems may arise with the timeliness, completeness, and accuracy of reports. Because audit is satisfactory, examiners may rely on audit results but because minor concerns exist, examiners may need to expand verification procedures in certain situations.

A rating of 3 indicates less-than-satisfactory audit performance. Audit identifies and reports weaknesses and risks; however, independence may be compromised and reports presented to the board or audit committee may be less than satisfactory in content and timeliness. Outstanding audit issues may not be adequately monitored. Risk analysis is less than satisfactory. As a result, the audit plan may not provide sufficient audit scope or frequency for IT operations, procurement, and development activities. Audit work is generally performed in accordance with professional auditing standards; however, occasional problems may be noted with the timeliness, completeness, or accuracy of reports. Because audit is less than satisfactory, examiners must use caution if they rely on the audit results.

A rating of 4 indicates deficient audit performance. Audit may identify weaknesses and risks, but it may not independently report to the board or audit committee, and report content may be inadequate. Outstanding audit issues may not be adequately monitored and resolved. Risk analysis is deficient. As a result, the audit plan does not provide adequate audit scope or frequency for IT operations, procurement, and development activities. Audit work is often inconsistent with professional auditing standards, and the timeliness, accuracy, and completeness of reports is unacceptable. Because audit is deficient, examiners cannot rely on audit results.

A rating of 5 indicates critically deficient audit performance. If an audit function exists, it lacks sufficient independence and, as a result, does not identify and report weaknesses or risks to the board or audit committee. Outstanding audit issues are not tracked and no follow-up is performed to monitor their resolution. Risk analysis is critically deficient. As a result, the audit plan is ineffective and provides inappropriate audit scope and frequency for IT operations, procurement, and development activities. Audit work is not performed in accordance with professional auditing standards and major deficiencies are noted regarding the timeliness, accuracy, and completeness of audit reports. Because audit is critically deficient, examiners cannot rely on audit results.

Management

The management rating reflects the abilities of the board and management as they apply to all aspects of IT acquisition, development, and operations. Management practices may need to address some or all of the following IT-related risks: strategic planning, quality assurance, project management, risk assessment, infrastructure and architecture, end-user computing, contract administration of third-party service providers, organization and human resources, and regulatory and legal compliance. Generally, directors need not be actively involved in day-to-day operations; however, they must provide clear guidance regarding acceptable risk-exposure levels and ensure that appropriate policies, procedures, and practices have been established. Sound management practices are demonstrated through active oversight by the board of directors and management, competent personnel, sound IT plans, adequate policies and standards, an effective control environment, and risk monitoring. The management rating should reflect the board's and management's ability as it applies to all aspects of IT operations. The performance of management and the quality of risk management are rated based on an assessment of factors such as—

- the level and quality of oversight and support of the IT activities by the board of directors and management;
- the ability of management to plan for and initiate new activities or products in response to information needs and to address risks that may arise from changing business conditions;
- the ability of management to provide information reports necessary for informed planning and decision making in an effective and efficient manner;
- the adequacy of, and conformance with, internal policies and controls addressing the IT operations and risks of significant business activities;
- the effectiveness of risk-monitoring systems;
- the timeliness of corrective action for reported and known problems;
- the level of awareness of and compliance with laws and regulations;
- the level of planning for management succession;
- the ability of management to monitor the services delivered and to measure the organization's progress toward identified goals effectively and efficiently;
- the adequacy of contracts and management's ability to monitor relationships with third-party servicers;
- the adequacy of strategic planning and risk-management practices to identify, measure, monitor, and control risks, including management's ability to perform self-assessments; and
- the ability of management to identify, measure, monitor, and control risks and to address emerging IT needs and solutions.

A rating of 1 indicates strong performance by management and the board. Effective risk-management practices are in place to guide IT activities, and risks are consistently and effectively identified, measured, controlled, and monitored. Management immediately resolves audit and regulatory concerns to ensure sound operations. Written technology plans, policies and procedures, and standards are thorough and properly reflect the complexity of the IT environment. They have been formally adopted, communicated, and enforced throughout the organization. IT systems provide accurate, timely reports to management. These reports serve as the basis for major decisions and as an effective performance-monitoring tool. Outsourcing arrangements are based on comprehensive planning; routine management supervision sustains an appropriate level of control over vendor contracts, performance, and services provided. Management and the board have demonstrated the ability to promptly and successfully address existing IT problems and potential risks.

A rating of 2 indicates satisfactory performance by management and the board. Adequate risk-management practices are in place and guide IT activities. Significant IT risks are identified, measured, monitored, and controlled; however, risk-management processes may be less structured or inconsistently applied and modest weaknesses exist. Management routinely resolves audit and regulatory concerns to ensure effective and sound operations; however, corrective actions may not always be implemented in a timely manner. Technology plans, policies and procedures, and standards are adequate and formally adopted. However, minor weaknesses may exist in management's ability to communicate and enforce them throughout the organization. IT systems provide quality reports to management which serve as a basis for major decisions and a tool for performance planning and monitoring. Isolated or temporary problems with timeliness, accuracy, or consistency of reports may exist. Outsourcing arrangements are adequately planned and controlled by management, and they provide for a general understanding of vendor contracts, performance standards, and services provided. Management and the board have demonstrated the ability to address existing IT problems and risks successfully.

A rating of 3 indicates less-than-satisfactory performance by management and the board. Risk-management practices may be weak and offer limited guidance for IT activities. Most IT risks are generally identified; however, processes to measure and monitor risk may be flawed. As a result, management's ability to control risk is less than satisfactory. Regulatory and audit concerns may be addressed, but time frames are often excessive and the corrective action taken may be inappropriate. Management may be unwilling or incapable of addressing deficiencies. Technology plans, policies and procedures, and standards exist but may be incomplete. They may not be formally adopted, effectively communicated, or enforced throughout the organization. IT systems provide requested reports to management, but periodic problems with accuracy, consistency, and timeliness lessen the reliability and usefulness of reports and may adversely affect decision making and performance monitoring. Outsourcing arrangements may be entered into without thorough planning. Management may provide only cursory supervision that limits their understanding of vendor contracts, performance standards, and services provided. Management and the board may not be capable of addressing existing IT problems and risks, which is evidenced by untimely corrective actions for outstanding IT problems.

A rating of 4 indicates deficient performance by management and the board. Risk-management practices are inadequate and do not provide sufficient guidance for IT activities. Critical IT risks are not properly identified, and processes to measure and monitor risks are deficient. As a result, management may not be aware of and is unable to control risks. Management may be unwilling or incapable of addressing audit and regulatory deficiencies in an effective and timely manner. Technology plans, policies and procedures, and standards are inadequate and have not been formally adopted or effectively communicated throughout the organization, and management does not effectively enforce them. IT systems do not routinely provide management with accurate, consistent, and reliable reports, thus contributing to ineffective performance monitoring or flawed decision making. Outsourcing arrangements may be entered into without planning or analysis, and management may provide little or no supervision of vendor contracts, performance standards, or services provided. Management and the board are unable to address existing IT problems and risks, as evidenced by ineffective actions and long-standing IT weaknesses. Strengthening of management and its processes is necessary.

A rating of 5 indicates critically deficient performance by management and the board. Risk-management practices are severely flawed and provide inadequate guidance for IT activities. Critical IT risks are not identified, and processes to measure and monitor risks do not exist or are not effective. Management's inability to control risk may threaten the continued viability of the institution. Management is unable or unwilling to correct audit- and regulatory-identified deficiencies, and immediate action by the board is required to preserve the viability of the institution. If they exist, technology plans, policies and procedures, and standards are critically deficient. Because of systemic problems, IT systems do not produce management reports that are accurate, timely, or relevant. Outsourcing arrangements may have been entered into without management planning or analysis, resulting in significant losses to the financial institution or ineffective vendor services.

Development and Acquisition

The rating of development and acquisition reflects an organization's ability to identify, acquire, install, and maintain appropriate IT resources. Management practices may need to address all or parts of the business process for implementing any kind of change to the hardware or software used. These business processes include an institution's purchase of hardware or software, development and programming performed by the institution, purchase of services from independent vendors or affiliated data centers, or a combination of these activities. The business process is defined as all phases taken to implement a change, including researching alternatives available, choosing an appropriate option for the organization as a whole, and converting to the new system or integrating the new system with existing systems. This rating reflects the adequacy of the institution's systems-development methodology and related risk-management practices for acquisition and deployment of IT. This rating also reflects the board and management's ability to enhance and replace IT prudently in a controlled environment. The performance of systems development and acquisition and related risk-management practice is rated based on an assessment of factors such as—

- the level and quality of oversight and support of systems-development and acquisition activities by senior management and the board of directors;
- the adequacy of the organizational and management structures to establish accountability and responsibility for IT systems and technology initiatives;
- the volume, nature, and extent of risk exposure to the financial institution in the area of systems development and acquisition;
- the adequacy of the institution's Systems Development Life Cycle (SDLC) and programming standards;
- the quality of project-management programs and practices that are followed by developers, operators, executive management or owners, independent vendors or affiliated servicers, and end-users;
- the independence of the quality-assurance function and the adequacy of controls over program changes;
- the quality and thoroughness of system documentation;
- the integrity and security of the network, system, and application software;
- the development of IT solutions that meet the needs of end-users; and
- the extent of end-user involvement in the system-development process.

A rating of 1 indicates strong systems-development, acquisition, implementation, and change-management performance. Management and the board routinely demonstrate successfully the ability to identify and implement appropriate IT solutions while effectively managing risk. Project-management techniques and the SDLC are fully effective and supported by written policies, procedures, and project controls that consistently result in timely and efficient project completion. An independent quality-assurance function provides strong controls over testing and program-change management. Technology solutions consistently meet end-user needs. No significant weaknesses or problems exist.

A rating of 2 indicates satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board frequently demonstrate the ability to identify and implement appropriate IT solutions while managing risk. Project management and the SDLC are generally effective; however, weaknesses may exist that result in minor project delays or cost overruns. An independent quality-assurance function provides adequate supervision of testing and program-change management, but minor weaknesses may exist. Technology solutions meet end-user needs. However, minor enhancements may be necessary to meet original user expectations. Weaknesses may exist; however, they are not significant and are easily corrected in the normal course of business.

A rating of 3 indicates less-than-satisfactory systems-development, acquisition, implementation, and change-management performance. Management and the board may often be unsuccessful in identifying and implementing appropriate IT solutions; therefore, unwarranted risk exposure may exist. Project-management techniques and the SDLC are weak and may result in frequent project delays, backlogs, or significant cost overruns. The quality-assurance function may not be independent of the programming function, which may have an adverse impact on the integrity of testing and program-change management. Technology solutions generally meet end-user needs but often require an inordinate level of change after implementation. Because of weaknesses, significant problems may arise that could result in disruption to operations or significant losses.

A rating of 4 indicates deficient systems-development, acquisition, implementation, and change-management performance. Management and the board may be unable to identify and implement appropriate IT solutions and do not effectively manage risk. Project-management techniques and the SDLC are ineffective and may result in severe project delays and cost overruns. The quality-assurance function is not fully effective and may not provide independent or comprehensive review of testing controls or program-change management. Technology solutions may not meet the critical needs of the organization. Problems and significant risks exist that require immediate action by the board and management to preserve the soundness of the institution.

A rating of 5 indicates critically deficient systems-development, acquisition, implementation, and change-management performance. Management and the board appear to be incapable of identifying and implementing appropriate IT solutions. If they exist, project-management techniques and the SDLC are critically deficient and provide little or no direction for development of systems or technology projects. The quality-assurance function is severely deficient or not present, and unidentified problems in testing and program-change management have caused significant IT risks. Technology solutions do not meet the needs of the organization. Serious problems and significant risks exist, which raise concern for the financial institution's ongoing viability.

Support and Delivery

The rating of support and delivery reflects an organization's ability to provide technology services in a secure environment. It reflects not only the condition of IT operations but also factors such as reliability, security, and integrity, which may affect the quality of the information-delivery system. The factors include user support and training, as well as the ability to manage problems and incidents, operations, system performance, capacity planning, and facility and data management. Risk-management practices should promote effective, safe, and sound IT operations that ensure the continuity of operations and the reliability and availability of data. The scope of this component rating includes operational risks throughout the organization. The rating of IT support and delivery is based on a review and assessment of requirements such as—

- the ability to provide a level of service that meets the requirements of the business;
- the adequacy of security policies, procedures, and practices in all units and at all levels of the financial institution;
- the adequacy of data controls over preparation, input, processing, and output;
- the adequacy of corporate contingency planning and business resumption for data centers, networks, and business units;
- the quality of processes or programs that monitor capacity and performance;
- the adequacy of controls and the ability to monitor controls at service providers;
- the quality of assistance provided to users, including the ability to handle problems;
- the adequacy of operating policies, procedures, and manuals;
- the quality of physical and electronic security, including the privacy of data; and
- the adequacy of firewall architectures and the security of connections with public networks.

A rating of 1 indicates strong IT support and delivery performance. The organization provides technology services that are reliable and consistent. Service levels adhere to well-defined service-level agreements and routinely meet or exceed business requirements. A comprehensive corporate contingency and business-resumption plan is in place. Annual contingency-plan testing and updating is performed, and critical systems and applications are recovered within acceptable time frames. A formal written data-security policy and awareness program is communicated and enforced throughout the organization. The logical and physical security for all IT platforms is closely monitored, and security incidents and weaknesses are identified and quickly corrected. Relationships with third-party service providers are closely monitored. IT operations are highly reliable, and risk exposure is successfully identified and controlled.

A rating of 2 indicates satisfactory IT support and delivery performance. The organization provides technology services that are generally reliable and consistent; however, minor discrepancies in service levels may occur. Service performance adheres to service agreements and meets business requirements. A corporate contingency and business-resumption plan is in place, but minor enhancements may be necessary. Annual plan testing and updating is performed, and minor problems may occur when recovering systems or applications. A written data-security policy is in place but may require improvement to ensure its adequacy. The policy is generally enforced and communicated throughout the organization, for example, through a security-awareness program. The logical and physical security for critical IT platforms is satisfactory. Systems are monitored, and security incidents and weaknesses are identified and resolved within reasonable time frames. Relationships with third-party service providers are monitored. Critical IT operations are reliable and risk exposure is reasonably identified and controlled.

A rating of 3 indicates that the performance of IT support and delivery is less than satisfactory and needs improvement. The organization provides technology services that may not be reliable or consistent. As a result, service levels periodically do not adhere to service-level agreements or meet business requirements. A corporate contingency and business-resumption plan is in place but may not be considered comprehensive. The plan is periodically tested;

however, the recovery of critical systems and applications is frequently unsuccessful. A data-security policy exists; however, it may not be strictly enforced or communicated throughout the organization. The logical and physical security for critical IT platforms is less than satisfactory. Systems are monitored; however, security incidents and weaknesses may not be resolved in a timely manner. Relationships with third-party service providers may not be adequately monitored. IT operations are not acceptable, and unwarranted risk exposures exist. If not corrected, weaknesses could cause performance degradation or disruption to operations.

A rating of 4 indicates deficient IT support and delivery performance. The organization provides technology services that are unreliable and inconsistent. Service-level agreements are poorly defined and service performance usually fails to meet business requirements. A corporate contingency and business-resumption plan may exist, but its content is critically deficient. If contingency testing is performed, management is typically unable to recover critical systems and applications. A data-security policy may not exist. As a result, serious supervisory concerns over security and the integrity of data exist. The logical and physical security for critical IT platforms is deficient. Systems may be monitored, but security incidents and weaknesses are not successfully identified or resolved. Relationships with third-party service providers are not monitored. IT operations are not reliable and significant risk exposure exists. Degradation in performance is evident and frequent disruption in operations has occurred.

A rating of 5 indicates critically deficient IT support and delivery performance. The organization provides technology services that are not reliable or consistent. Service-level agreements do not exist, and service performance does not meet business requirements. A corporate contingency and business-resumption plan does not exist. Contingency testing is not performed, and management has not demonstrated the ability to recover critical systems and applications. A data-security policy does not exist, and a serious threat to the organization's security and data integrity exists. The logical and physical security for critical IT platforms is inadequate, and management does not monitor systems for security incidents and weaknesses. Relationships with third-party service providers are not monitored, and the viability of a service provider may be in jeopardy. IT operations are severely deficient, and the seriousness of weaknesses could cause failure of the financial institution if not addressed.

OUTSOURCING INFORMATION TECHNOLOGY

Banking organizations are increasingly relying on services provided by other entities to support a range of banking operations. Outsourcing of information- and transaction-processing activities, either to affiliated institutions or third-party service providers, may help banking organizations manage data processing and related personnel costs, improve services, and obtain expertise not available internally. At the same time, the reduced operational control over outsourced activities may expose an institution to additional risks. The federal banking agencies have established procedures to examine and evaluate the adequacy of institutions' controls over service providers, which can be found in the FFIEC's *IT Handbook* and related guidance. Additional information on specific areas is provided in

- Section 4062.1, "Risk Management of Third-Party Relationships"
- SR-23-4, "Interagency Guidance on Third-Party Relationships: Risk Management"
- *Community Bank Access to Innovation through Partnerships* (September 2021)
- *Conducting Due Diligence on Financial Technology Companies: A Guide for Community Banks* (August 2021)

INFORMATION-PROCESSING ENVIRONMENT

Many factors influence an institution's decision about whether to use internal or external data processing services, including the initial investment, operating costs, and operational flexibility. Historically, small financial institutions, which usually lack the funds or transaction volume to justify an in-house information system, were the chief users of external data processing companies. However, as advances in technology have decreased the cost of data processing, small institutions have become much more willing to invest in an in-house information system. At the same time, some financial institutions with internal information systems have discovered that they can save money by using external data processing companies for certain banking applications. Other financial institutions have engaged national companies or facilities-management organizations to assume their processing operations, while certain holding companies have organized their data processing departments as subsidiaries to centralize operations for their affiliate institutions.

The decision to establish an internal data processing center is a major one. Any bank's board of directors and management considering such a decision should thoroughly review and consider alternatives before proceeding. While a bank may gain a number of competitive advantages from an in-house facility, there are also many risks associated with this decision. Technological advances have reduced the price of small computer networks and made them more affordable, but banks should not use this as the sole justification for an internal data processing center.

A comprehensive feasibility study should precede any decision to develop an in-house system. This study should describe the costs, benefits, and risks and also give management the opportunity to compare current and future needs with existing abilities. The FFIEC's *IT Handbook* contains a complete discussion of feasibility studies.

The management of a financial institution must carefully identify the organization's needs for data processing. After these needs are properly identified (including the customers' needs for these services), management must carefully evaluate how the institution can best meet them. The costs and complexity of changing data processing arrangements can be substantial, so management must ensure that all related costs and benefits are identified and considered before deciding on a service. The following are the major external providers of data processing and IT services for financial institutions.

Correspondent Banks

Small financial institutions sometimes receive their IT services from a major correspondent bank. These services may be just one of a host of services available from the correspondent. Historically, the correspondent bank has been the least expensive servicer for many institutions. Correspondent banks may offset some of their own IT costs by using their excess processing capacity to provide services to correspondents.

Affiliated Financial Institutions and Banking Organizations

IT departments in holding companies or subsidiaries are one common form of an affiliated servicer. An affiliated data center may offer cost savings to other affiliates, since all parties are generally using the same software system. The serviced institutions can eliminate the duplication of tasks, and the affiliated data center and the overall organization can realize cost savings through economies of scale. Thus, charges for IT services to affiliates are generally very competitive.

Regulatory guidelines strictly govern IT-servicing arrangements between affiliated institutions. Sections 23A and 23B of the Federal Reserve Act (12 U.S.C. 371c and 371c-1) address the question of allowable transactions between affiliates. This statute also states that the terms of transactions between affiliated parties must be comparable to the terms of similar transactions between nonaffiliated parties. An affiliated data center is allowed to set fees to recover its costs or to recover its costs plus a reasonable profit, or to set charges for data processing services that are comparable to those of a nonaffiliated servicer. Other restrictions may also apply.

Independent Service Bureaus

Independent service bureaus are present in most areas, but mergers and acquisitions have caused the number of bureaus to decline. When management investigates a service bureau's operations, it should determine if the servicer is familiar with the IT needs of financial institutions. Determining the percentage of the service bureau's business that comes from financial institutions will help the institution select a vendor that specializes in this type of processing. Independent service bureaus are normally responsive to user requests for specialized programs, since developing these programs for clients is generally a significant source of revenue. Tailoring a software program to a particular institution's needs becomes less attractive to the independent service bureau if the institution accounts for only a small portion of the bureau's workload or if the bureau offers a standardized software package as its primary product. However, some standardized software systems allow a modest amount of processing and report adjustments without requiring servicer modifications. Also, report-generator software, which provides clients with customized reports they can prepare without any help from the service bureau, is sometimes available from service bureaus.

Cooperative Service Corporations

A cooperative service corporation is a data processing facility formed by a group of financial institutions that agrees to share the operating costs. Under the right circumstances, this arrangement works well. For this strategy to succeed, however, all members of the group must be the same approximate size and have similar IT requirements. Typically, each institution owns a share of the facility or bears a share of the costs on a pro rata basis through investment in a bank service corporation. There must be a strong working relationship among the institutions. Although the institutions are not directly involved in the data processing center's daily operations, they are ultimately responsible for the center's success or failure.

One advantage of a cooperative service corporation is that individual institutions have increased control over the design of the data processing operation. Therefore, institutions can tailor computerized applications to meet their own needs. Resource pooling often provides for economies of scale as well, and cooperative ventures normally attract more highly skilled and more experienced employees.

Facilities-Management Providers

Medium- and large-sized financial institutions that already have an in-house data processing facility are the most likely users of facilities-management (FM) contracts. Small institutions typically do not have the work volume that is a prerequisite to hiring an FM company. Service contracts with FM companies are usually for a minimum term of five years, during which time the FM company assumes full responsibility for the institution's data processing operations. The institution pays the FM company a monthly fee to reimburse it for the costs of providing IT services plus a profit. The FM company usually carries out its tasks in the institution's former data processing center.

Financial institutions have various reasons for using FM companies, such as controlling or reducing the growth of data processing costs, ensuring better management of data center personnel, or using more modern software systems. Management of financially strained institutions may enter into FM arrangements to augment their capital position by selling their equipment or facilities to the FM company.

Although an institution's contract with an FM company may provide a quick and easy solution to data processing problems with minimal involvement of senior officials, management should be aware of potential problems. FM contracts can have clauses that require the institution to pay more for services as work volume grows and can also contain provisions for periodic increases. The contract may include a substantial penalty for cancellation. Another risk is that the FM company may make personnel changes that are not advantageous to the institution, such as reassigning its best workers elsewhere or reducing the size of the data processing staff. Bank management should make sure that FM service contracts contain specific quality-measurement clauses and should monitor the quality of data processing services provided.

Other Purchased Services

Computer Time

A financial institution that designed its own data processing system and that maintains its own files only needs to rent computer time from an external servicer. This arrangement usually occurs when the financial institution's equipment or schedule makes it unable to handle some unusual processing task.

Time-Shared Computer Services

Most external providers of time-sharing services have a library of standardized programs available to any user. A user also may generate programs and store them in a reserved library. Financial institutions frequently use time-sharing services for financial analysis rather than recordkeeping. Applications with low input and output requirements and repetitive calculations, such as those required for a securities portfolio, lend themselves to a time-sharing arrangement. The external servicer in this arrangement normally does not maintain the client institution's data files. Financial institutions that store master files on the external servicer's equipment should maintain adequate documentation to facilitate the examination process. Under this arrangement, management should be concerned about ensuring logical and physical access to the terminal and about the availability of audit trails that indicate who has made changes to master files. Management should establish and monitor controls over passwords, terminals, and access to master files. For a complete discussion of controls over passwords and terminals, see the FFIEC's *IT Handbook.*

Satellite Processing

Satellite (remote) processing has become popular with some financial institutions that are located far away from an external servicer and that must process a large volume of transactions. A distinguishing characteristic of satellite processing is that the institution and the data center each perform a portion of the processing. Although the institution collects the data and sometimes prepares reports, the servicer makes the necessary master-file updates. To capture data and print reports, the serviced institution must acquire a terminal-entry device, a printer, an MICR reader/sorter, and a tape or disk unit. Since the system is usually online, the serviced institution must install modems and communications lines linking it to the servicer. The level of skill necessary to perform remote job entry in a satellite system is less sophisticated than the level needed to operate an in-house system. Most of the traditional control functions remain at the institution. The FFIEC's *IT Handbook* contains further information on satellite processing, remote job entry, and distributive processing systems.

Standard Program Packages

Most bank data centers and service bureaus specialize in processing one or more standard software packages. By using the same software for several users, external servicers achieve certain operating economies, which allow them to recover initial development costs more quickly. Most standard software packages are parameter driven, providing the user with some degree of flexibility. For example, in demand deposit and savings applications, standard program modules or common subroutines often allow the user to designate the format and frequency of reports. In addition, the user may select the parameters necessary to generate certain reports, such as the number of inactive days before an account becomes dormant or the minimum dollar amount for checks listed on the large-item report. The user can also be involved in selecting the criteria for interest rates, balance requirements, and other operating values, allowing for a tailored application within a standardized software system.

Tailored Applications

If standard program packages do not meet a financial institution's needs, an external servicer can be hired to design tailored applications to process the institution's data. The institution must clearly describe the proposed system and its operations to the servicer. Internal or external auditor participation in reviewing controls is also advisable. The initial cost of this approach is high, as are the costs of maintaining and updating the tailored applications.

OPERATIONAL AND TECHNOLOGICAL USER CONTROLS

Using computerized programs and networks, banks maintain a large number of accounts and record a high volume of transactions every day. Text-processing systems store vast amounts of correspondence. Transmission of data and funds regularly occurs over public communications links, such as telephone lines and satellite networks. The use of new technologies to transfer funds and records, while improving customer service and the institution's internal operations, has increased the potential for errors and abuse, which can result in loss of funds, lawsuits arising from damaged reputations, improper disclosure of information, and regulatory sanctions.

Controls must be implemented to minimize the vulnerability of all information and to keep funds secure. Bank management must assess the level of control necessary in view of the degree of exposure and the impact of unexpected losses on the institution. Certain practices can strengthen information and financial security. The most basic practices are the implementation of sound policies, practices, and procedures for physical security, separation of duties, internal quality control, hardware and software access controls, and audits. Bank management should institute information security controls that are designed to—

- ensure the integrity and accuracy of management information systems;
- prevent unauthorized alteration during data creation, transfer, and storage;
- maintain confidentiality;
- restrict physical access;
- authenticate user access;
- verify the accuracy of processing during input and output;
- maintain backup and recovery capability; and
- provide environmental protection against damage or destruction of information.

Although security features vary, they are usually available for all computer systems. The controls adopted should apply to information produced and stored by both automated and manual methods.

Written policies are generally recommended and, in most cases, institutions have chosen to establish and communicate security principles in writing. However, if an institution follows sound fundamental principles to control the risks discussed here, a written policy is not necessarily required. If sound principles are not effectively practiced, management may be required to establish written policies to formally communicate risk parameters and controls. Federal Reserve System policy does, however, require written contingency and disaster-recovery plans.

Examiners should regularly conduct reviews of information security. These reviews may include an assessment of—

- the adequacy of security practices,
- compliance with security standards, and
- management supervision of information security activities.

When conducting reviews of controls over information security, examiners must understand the difference between master files and transaction files. A master file is a main reference file of information used in a computer system, such as all mortgage loans. It provides information to be used by the program and can be updated and maintained to reflect the results of the processed operation. A transaction file or detail file contains specific transaction information, such as mortgage loan payments.

Manual Controls

The following discussion covers basic operational controls in a financial institution receiving external IT services. Similar controls should also be applied to information processed by an IT department within a user's own institution.

Separation of Duties

A basic form of operational control is separation of duties. With this control in place, no one person should be able to both authorize and execute a transaction, thereby minimizing the risk of undetected improper activities. Data center personnel should not initiate transactions or correct data except when it is necessary to complete processing in a reasonable time period. If this unusual situation arises, proper authorization should be obtained from data center and bank management. Both the servicer and the serviced institution should maintain documentation of these approvals, including details of the circumstances requiring the action. The same person normally should not perform input and output duties. However, in some instances, staff limitations may make one person responsible for several activities, such as—

- preparing batches and blocks or other input for entry to the system or shipment to the servicer;
- operating data entry equipment, including check reader/sorter machines, proof machines, or data-conversion devices;
- preparing rejects and nonreaders for reentry into the system;

- reconciling output to input or balancing the system;
- distributing output to ultimate users; and
- posting the general ledger and balancing computer output to the general ledger.

Rotation of assignments and periodic scheduled absences may improve internal controls by preventing one person from controlling any one job for an extended time period (and by providing cross-training and backup for all personnel). When vacations are scheduled, management may require staff to take uninterrupted vacations that are long enough to allow pending transactions to clear. These practices are most effective if vacations or other types of absences extend over the end of an accounting period or are for two consecutive weeks. Written policies and procedures may require job rotation.

Application manuals usually consist of a user's guide provided by the servicer that is supplemented by procedures written by the user. Manuals normally cover the preparation and control of source documents, certain control practices for moving documents or electronic images to and from the user and servicer, the daily reconcilement of totals to the general ledger, and master-file changes.

Management should implement dual control over automated systems. Personnel should place supervisory holds on customer accounts requiring special attention. For example, dormant accounts, collateral accounts, and accounts with large uncollected funds balances generally have holds that can be removed only by authorizations from two bank officials. In addition, certain types of transactions (for example, master-file changes) should require authorization from two bank officials by means of special codes or terminal keys. When employees add or remove a hold on an account or when the system completes a transaction requiring supervisory approval, the computer should generate an exception report. Assigned personnel not involved in the transaction should promptly review these reports for unusual or unauthorized activity.

Internal Quality Controls

Generally, there are three basic types of information systems, with many combinations and variations:

- *Inquiry-only system.* This system allows the user to search and review machine-readable records but not to alter them. Controls and security concerns related to this system are few; the major concern is unauthorized access to confidential information.
- *Memo-post system.* More sophisticated than the inquiry-only system, the memo-post system allows the user to create interim records. The servicer performs permanent posting routines using batch-processing systems. Controls for a memo-post system include limiting physical and logical access to the system and restricting certain transactions to supervisory personnel only. Appropriate levels of management should review memo-post reports daily.
- *Online-post system.* This system, sometimes called a real-time system, requires the strictest controls. Online-post systems are vulnerable because all accepted transactions are transferred to machine-readable records. In addition to access controls, system reports should record all activity and exceptions. Appropriate levels of management should review these reports daily.

Internal controls fall into three general categories:

- *Administrative controls.* Administrative controls usually consist of management review of daily operations and output reports. Each application includes basic controls and exception reports that are common to all operations. To be effective, operations personnel must properly use exception reports and controls. This is especially true for controlling dormant accounts, check kiting, draws against uncollected funds, overdrafts, and the posting of computer-generated income and expense entries.
- *Dollar controls.* Dollar controls ensure processing for all authorized transactions. Operations personnel should establish work and control totals before forwarding data records to the data processor. Those same employees should not complete balancing procedures by reconciling trial balances to input, control sheets, and the general ledger. Report distribution should follow a formal procedure. Personnel should account for all rejects corrected and resubmitted.
- *Condoler controls.* Condoler controls are used when dollar values are not present in the data, as in name and address changes. Controls should be established before forwarding work

for processing. Management should also implement procedures designed to ensure that its servicer processes all condoler transactions. For example, personnel should check new-account reports against new-account input forms or written customer-account applications to make sure that data are properly entered. To protect data integrity, management should develop procedures to control master-file and program changes. These procedures should also verify that the servicer is making only authorized changes and ensure that data processing employees do not initiate master-file changes.

Technological Controls

Encryption

Encryption is a process by which mathematical algorithms are used to convert plain text into encrypted strings of meaningless symbols and characters. This helps prevent unauthorized viewing and altering of electronic data during transmission or storage. The industry commonly uses the Data Encryption Standard (DES) for encoding personal identification numbers (PINs) on access cards, storing user passwords, and transferring funds on large-dollar payment networks.

Message-Authentication Code

A message-authentication code (MAC) is a code designed to protect against unauthorized alteration of electronic data during transmission or storage. This code is used with data encryption to further secure the transmission of large-dollar payments.

User Passwords

User passwords consist of a unique string of characters that a programmer, computer operator, or user must supply before gaining access to the system or data. These are individual access codes that should be specific to the user and known only to the user. Other security features of passwords should, at a minimum, require the users to change them periodically and store them in encrypted files. In addition, the passwords should be composed of a sufficient number of alphanumeric characters to make them difficult to guess. User passwords should not be displayed during the access process and should not be printed on reports.

Security Software

Security software is software designed to restrict access to computer-based data, files, programs, utilities, and system commands. Some systems can control access by user, transaction, and terminal. The software can generate reports that log actual and attempted security violations as well as access to the system.

Restricted Terminals

Limiting certain types of transactions to certain terminals or groups of terminals can help reduce exposure to loss. The offsetting problem is that loss of the ability to use these terminals can stop processing for an entire application. Bank management should therefore evaluate both the exposure and processing risks.

An automatic time-out feature can minimize the exposure risk. Since unauthorized users may target an unattended terminal, this feature automatically signs off the user when there has been no activity for a certain period of time. Using time-of-day restrictions can also limit unauthorized use of terminals during periods when an entire department or section would be unattended.

Restricted Transactions

Restricted transactions are specialized transactions that can be performed only by supervisory or management personnel. Examples include reversing transactions, dollar adjustments to customer accounts, and daily balancing transactions. Management should periodically review user needs and the appropriateness of restricting the performance of these transactions. System-generated reports can be used to review this activity more frequently.

Activity and Exception Reports

Report output will vary, depending on the sophistication of the data communications and applications software. Management should receive activity reports that detail transactions by terminal, operator, and type. More sophisticated software will produce activity and exception reports on other criteria, such as the number of inquiries by terminal, unsuccessful attempts to access the system, unauthorized use of restricted information, and any unusual activities (that is, infrequently used transactions).

Activity reports are used to monitor system use and may not be printed daily. However, management should periodically review and summarize these reports in an effort to ensure that machines are used efficiently. Exception reports should be produced and reviewed daily by designated personnel who have no conflicting responsibilities. A problem with many reporting systems is that the log contains a record of every event, making it cumbersome and more difficult to identify problems.

Controls over Software-Program-Change Requests

Requests for system changes, such as software-program changes, should be documented on a standard change-request form. The form is used to describe the request and document the review and approval process. It should contain the following information:

- date of the change request
- sequential control number
- program or system identification
- reason for the change
- description of the requested change
- person requesting the change
- benefits contemplated from the change
- projected cost
- signed approval authorizing the change including, at a minimum, the user, IT personnel with the proper authority, and an auditor (at least for significant changes)
- name of programmer assigned to make the change
- anticipated completion date
- user and information systems approval of the completed program change
- implementation procedures (steps for getting the program into the production library)
- audit review of change (if deemed necessary)
- documented sign-off

End-User Computing

End-user computing results from the transfer of information-processing capabilities from centralized data centers onto the user's desktop. End-user computing systems may range in size and computing power from laptop notebook computers to standalone personal computers, client server networks, or small systems with sufficient computing power to process all significant applications for a financial institution. Small systems that are entirely supported by a hardware or software vendor are referred to as turnkey systems. Control considerations discussed throughout this subsection generally apply to all end-user computing systems.

In many cases, end-user systems are linked by distributed processing networks. Linking several microcomputers together and passing information between them is called networking. A system configured in this manner is commonly called a local area network (LAN). The ability to decentralize the data processing function is largely a result of the development of powerful microcomputers or PCs. Microcomputers are now powerful enough to process significant applications when used as standalone systems. These microcomputers can also be connected to a host computer and configured to serve as a data entry or display terminal. In this terminal-emulation mode, information can be passed between the host and the PC with the processing occurring at either machine.

When linked by a network, end-user computing offers several advantages to financial institutions, including—

- low cost compared with other platforms,
- efficiency through the sharing of resources,
- ease of expansion for future growth,
- enhanced communication capabilities,
- portability,
- data availability, and
- ease of use.

While end-user computing systems provide several advantages, they also have greater risks to data integrity and data security, including—

- difficulty in controlling access to the system and in controlling access to confidential information that may be stored on individual personal computers and not on the system (such as payroll records, spreadsheets, budgets, and

information intended for the board of directors of the financial institution),
- the lack of sophisticated software to ensure security and data integrity,
- insufficient capabilities to establish audit trails,
- inadequate program testing and documentation,
- lack of segregated duties of data entry personnel.

As the trend toward distributed processing continues, financial institutions should have proper policies, procedures, and reporting to ensure the accurate and timely processing of information. The controls governing access in an end-user computing environment should be no less stringent than those used in a traditional mainframe environment. Strict rules should govern the ability of users to access information. As a general rule, no user should be able to access information that is beyond what is needed to perform the tasks required by his or her job description. In this new environment, management and staff should assume responsibility for the information assets of the organization.

CONTINGENCY PLANNING, RECORD PROTECTION, AND RETENTION

Data communications systems are susceptible to software, hardware, and transmission problems that may make them unusable for extended periods of time. If a financial institution depends on data communication for its daily operations, appropriate back-up provisions are necessary. Back-up is the ability to continue processing applications in the event the communications system fails. Management can provide back-up by various methods, including batch-processing systems, intelligent terminals or PCs operating in an off-line mode, data capture at the controller if transmission lines are lost, redundant data communication lines, and back-up modems.

Regardless of the method used, FFIEC interagency issuances and specific supporting Federal Reserve System policy issuances that address corporate contingency planning require a comprehensive back-up plan with detailed procedures. When using a batch back-up system, operations personnel must convert data to a machine-readable format and transport the data to the servicer. This process may require additional personnel (data-entry operators and messengers) and equipment. An institution's contingency plan should include detailed procedures on how to obtain and use the personnel and equipment. Because on-line systems are updated or improved frequently, a batch back-up may not remain compatible. Institution personnel should perform periodic tests of batch and other back-up capabilities to ensure that protection is available and that employees are familiar with the plan.

Institutions should create computerized back-up copies of the institution's critical records and have alternative methods of processing those records. When IT operations are performed outside the institution, both the servicer and the financial institution should have adequate control over the records. Bank management should determine which records are best protected by the servicer and which are best protected internally. Service contracts should outline the servicer's responsibility for storing bank records. If the servicer does not or will not permit specific reference to record retention in the contract, a general reference may be sufficient. The institution should obtain a copy of the servicer's back-up policy and retention procedures, and bank management should thoroughly understand which records are protected by whom and to what extent.

The bank should also review the servicer's software and hardware back-up arrangements. It should review the service provider's contingency plan and results of routine tests of the contingency plan. The review should determine how often data and software back-ups are made, the location of stored materials, and which materials are stored at that site. Management should also determine the availability of software replacement and vendor support, as well as the amount and location of duplicate software documentation. Software replacement and documentation procedures should be developed for both operating and application systems.

Management should review the servicer's hardware back-up arrangements to determine if (1) the servicer has a contract with a national recovery service and, if so, the amount and type of back-up capacity provided under the contract; (2) the servicer has an alternate data center with sufficient capacity and personnel to provide full service if necessary; or (3) multiple processing sites within the same facility are available for disaster-processing problems and if each site has an alternate power supply. The alternate site should be able to provide continued processing of data and transmission of reports.

Contracts or contingency plans should specify the availability of source documentation in the event of a disaster, including insolvency of the servicer. FFIEC interagency issuances and Federal Reserve System policy statements require financial institutions to evaluate the adequacy of a servicer's contingency plan and to ensure that its own contingency plan is compatible with the servicer's plan.

Since the duplication of records may vary from site to site, most organizations develop schedules for automatic retention of records on a case-by-case basis. The only way to ensure sufficient record protection is to continually review the flow of documents, data, and reports. Some records may be available in both hard-copy and machine-readable formats. In addition to determining the types of back-up records, management should determine whether it is possible to re-create current data from older records. Certain records also have uses apart from their value in reconstructing current data, such as meeting institutional and regulatory reporting requirements. These records usually include month-end, quarter-end, and year-end files.

The location of an external data center is another factor to consider when evaluating retention procedures. If the external data center is located in a building adjacent to the institution, the possibility that a disaster may affect both organizations increases. Such a situation may make off-site storage of back-up materials even more important. If, on the other hand, the serviced institution is located far from the data center, physical shipment of both input and output may become necessary. Management should determine if fast, reliable transportation between the two sites is available.

If a major disaster occurs, an alternate facility may not be available to process duplicated machine-readable media. Management should consider remote record storage that would facilitate the manual processing of records, if necessary. Furthermore, microfilming all items before shipment would protect the institution if any items are lost, misplaced, or destroyed. Optical-disk storage, which involves scanning and storing a document electronically, offers another alternative for storage and retrieval of original data after processing has occurred. The FFIEC's *IS Handbook* and related FFIEC and Federal Reserve System issuances are sources of information about planning for unexpected contingencies.

Processing personnel should regularly copy and store critical institution records in an off-site location that is sufficiently accessible to obtain records in a reasonable time period. These records should include data files, programs, operating systems, and related documentation. This also applies to critical data in hard-copy documents. In addition, an inventory of the stored information should be maintained along with a defined retention period.

AUDITS

Examiners need to determine the appropriateness of the scope and frequency of audit activities related to information systems and the reliability of internal or third-party audits of servicer-processed work. Furthermore, examiners should review the methods by which the board of directors is apprised of audit findings, recommendations, and corrective actions taken. In reviewing audit activities, examiners should consider the following factors (if applicable):

- the practicality of the financial institution's having an internal IT auditor and, if the institution has an internal IT auditor, the auditor's level of training and experience
- the training and experience of the institution's external auditors
- the audit functions performed by the institution's outside auditors, the servicer, the servicer's outside auditor, and supervisory personnel
- internal IT audit techniques currently being followed

The audit function should review controls and operating procedures that help protect the institution from losses caused by irregularities and willful manipulations of the data processing system. Thus, a regular, comprehensive audit of IT activities is necessary. Additionally, designated personnel at each serviced institution should periodically perform "around-the-computer" audit examinations, such as:

- developing data controls (proof totals, batch totals, document counts, number of accounts, and prenumbered documents) at the institution before submitting data to the servicer and sampling the controls periodically to ensure their accuracy;

- spot-checking reconcilement procedures to ensure that output totals agree with input totals, less any rejects;
- sampling rejected, unpostable, holdover, and suspense items to determine why they cannot be processed and how they were disposed of (to make sure they were properly corrected and re-entered on a timely basis);
- verifying selected master-file information (such as service-charge codes), reviewing exception reports, and cross-checking loan extensions to source documents;
- spot-checking computer calculations, such as the dollar amounts of loan rebates, interest on deposits, late charges, service charges, and past-due loans, to ensure proper calculations;
- tracing transactions to final disposition to ensure audit trails are adequate;
- reviewing source documents to ascertain whether sensitive master-file change requests were given the required supervisory approval;
- assessing the current status of controls by either visiting the servicer or reviewing independent third-party reviews of the servicer;
- reviewing processing procedures and controls; and
- evaluating other audits of the servicer.

In addition, "through-the-computer" audit techniques allow the auditor to use the computer to check data processing steps. Audit software programs are available to test extensions and footings and to prepare verification statements.

Regardless of whether an institution processes data internally or externally, the board of directors must provide an adequate audit program for all automated records. If the institution has no internal IT audit expertise, the nontechnical "around-the-computer" methods will provide minimum coverage, but not necessarily adequate coverage. A comprehensive external IT audit, similar to those discussed in the FFIEC's *IS Handbook*, should be carried out to supplement nontechnical methods.

INSURANCE

A financial institution should periodically review its insurance coverage to ensure that the amount of coverage is adequate to cover any exposure that may arise from using an external IT provider. To determine what coverage is needed, the institution should review its internal operations, the transmission or transportation of records or data, and the type of processing performed by the servicer. This review should identify risks to data, namely the accountability for data, at both the user and servicer locations and while in transit. Insurance covering physical disasters, such as fires, floods, and explosions, should be sufficient to cover replacement of the data processing system. Coverage that protects specialized computer and communications equipment may be more desirable than the coverage provided by regular hazard insurance. Expanded coverage protects against water infiltration, mechanical breakdown, electrical disturbances, changes in temperature, and corrosion. The use of an "agreed-amount" endorsement can provide for full recovery of covered loss.

Bank management should also review the servicer's insurance coverage to determine if the amounts and types are adequate. Servicer coverage should be similar to what the financial institution would normally purchase if it were performing its data processing internally. Servicer-provided coverage should complement and supplement the bank's coverage.

If a loss is claimed under the user's coverage, the user need only prove that a loss occurred to make a claim. However, if the loss is claimed under the servicer's coverage, the institution must prove that a loss occurred and also that the servicer was responsible for the loss.

Examiners should review the serviced institution's blanket bond coverage, as well as similar coverage provided by the servicer. The coverage period may be stated in terms of a fixed time period. The loss, the discovery, and the reporting of the loss to the insurer must occur during that stated period. Extended discovery periods are generally available at additional cost if an institution does not renew its bond. The dollar amount of the coverage now represents an aggregate for the stated period. Each claim paid, including the loss, court costs, and legal fees, reduces the outstanding amount of coverage, and recoveries do not reinstate previous levels of coverage. Since coverage extends only to locations stated in the policy, the policy must individually list all offices. Additionally, policies no longer cover certain types of documents in transit.

The bank's board of directors should be involved in determining insurance coverage since each board member will be acknowledging the terms, conditions, fees, riders, and exclusions of the policy. Insurance companies consider any provided information as a warranty of coverage. Any omission of substantive information could result in voided coverage.

The bank or servicer should consider buying additional coverage. Media-reconstruction policies defray costs associated with recovering data contained on the magnetic media. Media-replacement policies replace blank media. Extra-expense policies reimburse organizations for expenses incurred over and above the normal cost of operations. In addition, servicers often purchase policies covering unforeseen business interruptions and the liabilities associated with errors and omissions. Both servicer and banking organizations may purchase transit insurance that covers the physical shipment of source documents. Additionally, electronic funds transfer system (EFTS) liability coverage is available for those operations that use electronic transmission.

Several factors may influence an institution's decision to purchase insurance coverage or to self-insure: the cost of coverage versus the probability of occurrence of a loss, the cost of coverage versus the size of the loss of each occurrence, and the cost of coverage versus the cost of correcting a situation that could result in a loss. Some institutions engage risk consultants to evaluate these risks and the costs of insuring against them.

SERVICE CONTRACTS

Contract Practices

A poorly written or inadequately reviewed contract can be troublesome for both the serviced financial institution and the servicer. To avoid or minimize contract problems, bank legal counsel who are familiar with the terminology and specific requirements of a data processing contract should review it to protect the institution's interests. Since the contract likely sets the terms for a multiyear understanding between the parties, all items agreed on during negotiations must be included in the final signed contract. Verbal agreements are generally not enforceable, and contracts should include wording such as "no oral representations apply" to protect both parties from future misunderstandings. The contract should also establish baseline performance standards for data processing services and define each party's responsibilities and liabilities, where possible.

Although contracts between financial institutions and external data processing companies are not standardized in a form, they share a number of common elements. For a further discussion of IT contract elements and considerations, see the FFIEC's *IS Handbook*.

Additionally, section 225 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) states, "An [FDIC-] insured depository institution may not enter into a written or oral contract with any person to provide goods, products or services to or for the benefit of such depository institution if the performance of such contract would adversely affect the safety or soundness of the institution." An institution should ascertain during contract negotiations whether the servicer can provide a level of service that meets the needs of the institution over the life of the contract. The institution is also responsible for making sure it accounts for each contract in accordance with GAAP. Regulatory agencies consider contracting for excessive servicing fees and/or failing to properly account for such transactions an unsafe and unsound practice. When entering into service agreements, banks must ensure that the method by which they account for such agreements reflects the substance of the transaction and not merely its form. See FFIEC Supervisory Policy SP-6, "Interagency Statement on EDP Service Contracts."

Risk of Termination

Many financial institutions have become so dependent on outside data processing servicers that any extended interruption or termination of service would severely disrupt normal operations. Termination of services generally occurs according to the terms of the service contract. Banks may also experience an interruption of services that is caused by a physical disaster to the servicer, such as a fire or flood, or by bankruptcy. The serviced institution must prepare differently for each type of termination. The contract should allow either party to terminate the agreement by notifying the other party 90 to 180 days in advance of the termination date, which should give a serviced institution adequate time to locate and contract with another servicer.

Termination caused by physical disaster occurs infrequently, but it may present the institution with a more serious problem than termination by contract. However, if the servicer has complied with basic industry standards and maintains a proper contingency plan, disruption of services to users will ordinarily be minimal. The contingency plan must require the servicer to maintain current data files and programs at an alternate site and arrange for back-up processing time with another data center. At a minimum, these provisions should allow the servicer to process the most important data applications. Since equipment vendors can often replace damaged machines within a few days, the servicer should be able to resume processing with little delay. The servicer, not the serviced institution, is responsible for the major provisions of its back-up contingency plan. However, the institution must have a plan that complements the servicer's.

Termination caused by bankruptcy of the servicer is potentially the most devastating to a serviced institution. There may not be advance notice of termination or an effective contingency plan (because servicer personnel may not be available). In this situation, the serviced institution is responsible for finding an alternate processing site.

Although user institutions can ordinarily obtain data files from a bankrupt servicer with little trouble, the programs (source code) and documentation required to process those files are normally owned by the servicer and are not available to the user institutions. These programs are often the servicer's only significant assets. Therefore, a creditor of a bankrupt servicer, in an attempt to recover outstanding debts, will seek to attach those assets and further limit their availability to user institutions. The bankruptcy court may provide remedies to the user institutions, but only after an extended length of time.

An escrow agreement is an alternative to giving vendors sole control of the source code. In this agreement, which should either be part of the service contract or a separate document, the financial institution would receive the right to access source programs under certain conditions, such as discontinued product support or the financial insolvency of the vendor. A third party would retain these programs and related documents in escrow. Periodically, the financial institution should determine that the source code maintained in escrow is up-to-date, for example, an independent party should verify the version number of the software. Without an escrow agreement, a serviced institution has two alternatives: (1) pay off the creditor and hire outside specialists to operate the center or (2) convert data files to another servicer. Either alternative is likely to be costly and cause severe operating delays.

Institutions should normally determine the financial viability of its servicer annually. Once the review is complete, management must report the results to the board of directors or a designated committee. At a minimum, management's review should contain a careful analysis of the servicer's annual financial statement. Management may also use other sources of information to determine a servicer's condition, such as investment analyst reports and bond ratings. Reports of independent auditors and examination reports for certain service providers obtainable from appropriate regulatory agencies may contain useful information.

AUTOMATED CLEARINGHOUSE

Automated clearinghouses (ACHs) form a nationwide electronic payments system used by a large number of depository institutions and corporations. ACH rules and regulations are established by the National Automated Clearing House Association (NACHA) and the local ACH associations, and they are referenced in the ACH operating circulars of the Federal Reserve Banks.

ACH is a value-based system that supports both credit and debit transactions. In ACH credit transactions, funds flow from the depository institution originating the transaction to the institutions receiving the transactions. Examples of credit payments include direct deposits of payroll, dividend and interest payments, Social Security payments, and corporate payments to contractors and vendors. In a debit transaction, funds flow from the depository institutions receiving the transaction instructions to the institution originating the transaction. Examples of ACH debit transactions include collection of insurance premiums, mortgage and loan payments, consumer bill payments, and transactions to facilitate corporate cash management. ACH transactions are deposited in batches at Federal Reserve Banks (or private-sector ACH processors) for processing one or two business days before the settlement date. These transactions are processed and delivered to the receiving institutions through the nightly processing cycle for a given day.

ACH transactions continue to grow significantly. Additional uses of the ACH continue to be developed as depository institutions, corporations, and consumers realize its efficiency and low cost compared with large-dollar payments systems and check payments. One area of growth is the use of debit transactions for the collection of large payments due to the originator, such as the cash concentration of a company's nationwide branch or subsidiary accounts into one central account and other recurring contractual payments.

While several organizations can be involved in processing ACH transactions, the Federal Reserve System is the principal ACH processor. For the Federal Reserve ACH system, depository institutions send ACH transactions to and receive ACH transactions from one of the Federal Reserve processing sites via a communications system linking each location. Access may be by direct computer interface or intelligent terminal connections.

As with any funds-transfer system, the ACH system has inherent risks, including error, credit risk, and fraud. When reviewing ACH activities, examiners should evaluate the following:

- agreements covering delivery and settlement arrangements maintained by the depository institution as an originator or receiver of ACH transactions
- monitoring of the institution's and customer's intraday positions
- balancing procedures of ACH transactions processed
- the credit policy and effectiveness of procedures to control intraday and overnight overdrafts, resulting from extensions of credit to an ACH customer, to cover the value of credit transfers originated (Since ACH transactions may be originated one or two days before the settlement date, the originating institution is exposed to risk from the time it submits ACH credit transfers to the ACH processor to the time its customer funds those transfers.)
- uncollected-funds controls and the related credit policy for deposits created through ACH debit transactions (ACH debits can be returned for insufficient funds in the payor's account or for other reasons, such as a court order.)
- exception reports (that is, large-item and new-account reports)
- control procedures for terminals through which additions, deletions, and other forms of maintenance could be made to customer databases
- the retention of all entries, return entries, and adjustment entries transmitted to and received from the ACH for a period of six years after the date of transmittal

RETAIL FUNDS-TRANSFER SYSTEMS

Automation has enabled banks to electronically perform many retail banking functions formerly handled manually by tellers, bookkeepers, data-entry clerks, and other banking personnel. Accordingly, the need for physical banking facilities and related staff has been reduced. Electronic funds transfer (EFT) and related banking services have also brought access to and control of accounts closer to the consumer through the use of widely distributed unmanned terminals and merchant facilities. EFT-related risk to a financial institution for individual customer transactions is generally low, since the transactions are usually for relatively small amounts. However, weaknesses in controls that could lead to incorrect or improper use of several accounts could lead to significant losses or class action suits against a financial institution. Examinations of retail EFT facilities should focus on the potential large-scale risks of a given product. Examples of retail EFT systems include automated teller machines, point-of-sale networks, debit and "smart" cards, and home banking.

Automated Teller Machines

An automated teller machine (ATM) is a terminal that is capable of performing many routine banking services for the customer. ATMs handle deposits, transfers between savings and checking accounts, balance inquiries, withdrawals, small short-term loans, and loan payments. ATMs may also handle other transactions, such as cash advances on credit cards, statement printing, and postage-stamp dispensing. ATMs usually operate 24 hours a day and are located not only on bank premises but in other locations, such as shopping malls and businesses. Daily withdrawals are usually, and should be, limited to relatively small amounts ($200 to $500). Deposits are processed in the same manner as if they were handled by a teller. ATMs are generally activated through the use of a plastic card encoded with a machine-readable customer identification number and the customer's entry of a corresponding personal identification number (PIN). Some financial institutions may refer to this identification number as the personal identification code (PIC).

ATMs operate in either off-line or on-line mode. Off-line transactions are those that occur when the customer's account balance is not available for verification. This situation can be the result of telecommunication problems between the financial institution and the ATM network. In addition, an off-line transaction can occur when a customer's account balance is not available because the financial institution is updating its files. Financial institutions usually update their files during low-volume periods. In either case, transactions are usually approved up to the daily withdrawal limit, which is a risk to the bank because a customer can withdraw more than is available in the account. On-line systems are directly connected to a financial institution's computer system and the corresponding customer account information. The computer processes each transaction immediately and provides immediate account-balance verification. With either system, a card is normally captured (kept by the ATM) if misuse is indicated (for example, the card has been reported stolen or too many attempts have been made with an invalid PIN).

Financial institutions are usually members of several ATM networks, which can be regional and national. Through these networks, separate institutions allow each other's customers to use their ATM machines. This is known as an interchange system. To be involved in an interchange system, a financial institution must either be an owner or member of the ATM network.

Fraud, robbery, and malfunction are the major risks of ATMs. The use of plastic cards and PINs are a deterrent, but there is still the risk that an unauthorized individual may obtain them. Customers may even be physically accosted while making withdrawals or deposits at ATM locations. Institutions have decreased this risk by installing surveillance cameras and access-control devices. For example, the ATM card can be used as an access-control device, unlocking the door to a separate ATM enclosure and relocking it after the customer has entered. Fraud may also result from risks associated with the issuance of ATM cards, the capture of cards, and the handling of customer PINs. Appropriate controls are needed to prevent the financial institution's personnel from unauthorized access to unissued cards, PINs, and captured cards.

Point-of-Sale Systems

A point-of-sale (POS) system transaction is defined as an electronic transfer of funds from a customer's checking or savings account to a merchant's account to pay for goods or services. Transactions are initiated from POS terminals located in department stores, supermarkets, gasoline stations, and other retail outlets. In an electronic POS system, a customer pays for purchases using a plastic card (such as an ATM, credit, or debit card). The store clerk enters the payment information into the POS terminal, and the customer verifies the transaction by entering a PIN. This results in a debit to the customer's account and a credit to the merchant's account.

POS transactions may be processed through either single-institution unshared systems or multi-institution shared networks. Participants in a shared system settle daily, on a net transaction basis, between each other. In unshared systems, the merchants and customers have accounts with the same financial institution. Thus, the need to settle between banks is eliminated.

As with other EFT systems, POS transactions are subject to the risk of loss from fraud, mistakes, and system malfunction. POS fraud is caused by stolen cards and PINs, counterfeit cards, and unauthorized direct computer access. The system is also susceptible to errors such as debiting or crediting an account by too much or too little, or entering unauthorized transactions. For the most part, POS systems usually deal with these risks by executing bank-merchant and bank-customer contracts that delineate each party's liabilities and responsibilities. Also, consumers are protected by state and federal statutes limiting their liability if they give notice of a lost, stolen, or mutilated card within a specified time period. Other risks inherent in POS systems are computer malfunction or downtime.

Financial institutions offering POS services should provide for back-up of their records through adequate contingency planning. Internal control guidelines for POS systems should address the following:

- confidentiality and security of customer-account information, including protection of PINs
- maintenance of contracts between banks and merchants, customers and banks, and banks and networks
- policies and procedures for credit and check authorization, floor limits, overrides, and settlement and balancing
- maintenance of transaction journals to provide an adequate audit trail
- generation and review of daily exception reports with provisions for follow-up of exception items
- provisions for back-up and contingency planning
- physical security surrounding POS terminals

Internal Controls for Retail EFT Systems

Regardless of the EFT system employed, financial institutions should ensure that adequate internal controls are in place to minimize errors, discourage fraud, and provide an adequate audit trail. Recommended internal-control guidelines for all systems include:

- establishing measures to establish proper customer identification (such as PINs) and maintain their confidentiality
- installing a dependable file-maintenance and retention system to trace transactions
- producing, reviewing, and maintaining exception reports to provide an audit trail

The most critical element of EFT systems is the need for undisputed identification of the customer. Particular attention should be given to the customer-identification systems. The most common control is the issuance of a unique PIN that is used in conjunction with a plastic card or, for noncard systems, an account number. The following PIN control guidelines, as recommended by the American Bankers Association, are encouraged.

Storage:

- PINs should not be stored on other source instruments (for example, plastic cards).
- Unissued PINs should never be stored before they are issued. They should be calculated when issued, and any temporary computer storage areas used in the calculation should be cleared immediately after use.
- PINs should be encrypted on all files and databases.

Delivery:

- PINs should not appear in printed form where they can be associated with customers' account numbers.
- Bank personnel should not have the capability to retrieve or display customers' PIN numbers.
- All the maintenance to PINs stored in databases should be restricted. Console logs and security reports should be reviewed to determine any attempts to subvert the PIN security system.
- PIN mailers should be processed and delivered with the same security accorded the delivery of bank cards to cardholders. (They should never be mailed to a customer together with the card).

Usage:

- The PIN should be entered only by the cardholder and only in an environment that deters casual observation of entries.
- The PIN should never be transmitted in unencrypted form.
- PIN systems should record the number of unsuccessful PIN entries and should restrict access to a customer's account after a limited number of attempts.
- If a PIN is forgotten, the customer should select a new one rather than have bank personnel retrieve the old one, unless the bank has the ability to generate and mail a hard copy of the PIN directly to the customer without giving bank personnel the ability to view the PIN.

Control and security:

- Systems should be designed, tested, and controlled to preclude retrieval of stored PINs in any form.

- Application programs and other software containing formulas, algorithms, and data used to calculate PINs must be subject to the highest level of access control for security purposes.
- Any data-recording medium, for example, magnetic tape and removable disks, used in the process of assigning, distributing, calculating, or encrypting PINs must be cleared immediately after use.
- Employees with access to PIN information must be subject to security clearance and must be covered by an adequate surety bond.

System design:

- PIN systems should be designed so that PINs can be changed without reissuing cards.
- PINs used on interchange systems should be designed so that they can be used or changed without any modification to other participants' systems.
- Financial institutions electing to use encryption as a security technique for bank card systems are strongly encouraged to consider the data encryption standards established by the National Institute of Standards and Technology.

In addition, institutions should consider controls over other aspects of the process. Control guidelines appropriate for plastic cards include those covering procurement, embossing or encoding, storage, and mailing. Controls over terminal sharing and network switching are also appropriate. Institutions should address backup procedures and practices for retail funds-transfer systems and insurance coverage for these activities.

APPENDIX—INTERAGENCY GUIDELINES ESTABLISHING INFORMATION SECURITY STANDARDS

Sections II and III of the information security standards are provided below. For more information, see the Interagency Guidelines Establishing Information Security Standards, in Regulation H, section 208, appendix D-2 (12 CFR 208, appendix D-2). The guidelines were previously titled Interagency Guidelines Establishing Standards for Safeguarding Customer Information. The information security standards were amended, effective July 1, 2005, to implement section 216 of the Fair and Accurate Credit Transactions Act of 2003 (the FACT Act). To address the risks associated with identity theft, the amendments generally require financial institutions to develop, implement, and maintain, as part of their existing information security program, appropriate measures to properly dispose of consumer information derived from consumer reports. The term *consumer information* is defined in the revised rule.

II. Standards for Safeguarding Customer Information

A. Information Security Program

Each bank is to implement a comprehensive written information security program that includes administrative, technical, and physical safeguards appropriate to the size and complexity of the bank and the nature and scope of its activities. While all parts of the bank are not required to implement a uniform set of policies, all elements of the information security program are to be coordinated. A bank is also to ensure that each of its subsidiaries is subject to a comprehensive information security program. The bank may fulfill this requirement either by including a subsidiary within the scope of the bank's comprehensive information security program or by causing the subsidiary to implement a separate comprehensive information security program in accordance with the standards and procedures in sections II and III that apply to banks.

B. Objectives

A bank's information security program shall be designed to—

1. ensure the security and confidentiality of customer information;
2. protect against any anticipated threats or hazards to the security or integrity of such information;
3. protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer; and

4. ensure the proper disposal of customer information and consumer information.

III. Development and Implementation of Information Security Program

A. Involve the Board of Directors

The board of directors or an appropriate committee of the board of each bank is to—

1. approve the bank's written information security program; and
2. oversee the development, implementation, and maintenance of the bank's information security program, including assigning specific responsibility for its implementation and reviewing reports from management.

B. Assess Risk

Each bank is to—

1. identify reasonably foreseeable internal and external threats that could result in unauthorized disclosure, misuse, alteration, or destruction of customer information or customer information systems;
2. assess the likelihood and potential damage of these threats, taking into consideration the sensitivity of customer information;
3. assess the sufficiency of policies, procedures, customer information systems, and other arrangements in place to control risks; and
4. ensure the proper disposal of customer information and consumer information.

C. Manage and Control Risk

Each bank is to—

1. Design its information security program to control the identified risks, commensurate with the sensitivity of the information as well as the complexity and scope of the bank's activities. Each bank must consider whether the following security measures are appropriate for the bank and, if so, adopt those measures the bank concludes are appropriate:
   a. access controls on customer information systems, including controls to authenticate and permit access only to authorized individuals and controls to prevent employees from providing customer information to unauthorized individuals who may seek to obtain this information through fraudulent means
   b. access restrictions at physical locations containing customer information, such as buildings, computer facilities, and records storage facilities to permit access only to authorized individuals
   c. encryption of electronic customer information, including while in transit or in storage on networks or systems to which unauthorized individuals may have access
   d. procedures designed to ensure that customer information system modifications are consistent with the bank's information security program
   e. dual control procedures, segregation of duties, and employee background checks for employees with responsibilities for or access to customer information
   f. monitoring systems and procedures to detect actual and attempted attacks on or intrusions into customer information systems
   g. response programs that specify actions to be taken when the bank suspects or detects that unauthorized individuals have gained access to customer information systems, including appropriate reports to regulatory and law enforcement agencies
   h. measures to protect against destruction, loss, or damage of customer information due to potential environmental hazards, such as fire and water damage or technological failures
2. Train staff to implement the bank's information security program.
3. Regularly test the key controls, systems, and procedures of the information security program. The frequency and nature of such tests should be determined by the bank's risk assessment. Tests should be conducted or reviewed by independent third parties or staff independent of those that develop or maintain the security programs.
4. Develop, implement, and maintain, as part of its information security program, appropriate measures to properly dispose of customer information and consumer information in accordance with each of the requirements in this section III.

D. Oversee Service-Provider Arrangements

Each bank is to—

1. exercise appropriate due diligence in selecting its service providers;
2. require its service providers by contract to implement appropriate measures designed to meet the objectives of the information security standards; and
3. where indicated by the bank's risk assessment, monitor its service providers to confirm that they have satisfied their obligations with regard to the requirements for overseeing provider arrangements. As part of this monitoring, a bank should review audits, summaries of test results, or other equivalent evaluations of its service providers.

E. Adjust the Program

Each bank is to monitor, evaluate, and adjust, as appropriate, the information security program in light of any relevant changes in technology, the sensitivity of its customer information, internal or external threats to information, and the bank's own changing business arrangements, such as mergers and acquisitions, alliances and joint ventures, outsourcing arrangements, and changes to customer information systems.

F. Report to the Board

Each bank is to report to its board or an appropriate committee of the board at least annually. This report should describe the overall status of the information security program and the bank's compliance with the information security standards. The reports should discuss material matters related to its program, addressing issues such as risk assessment; risk management and control decisions; service-provider arrangements; results of testing; security breaches or violations and management's responses; and recommendations for changes in the information security program.

G. Implement the Standards

(For the effective dates, see 12 CFR 208, appendix D-2, section III.G.)

Information about banks' information technology activities and examination procedures can be found in the *FFIEC Information Technology Handbook* (*IT Handbook*), which is used by examiners at the Federal Reserve and the other federal banking agencies.

Electronic and Internet banking products and services have been widely adopted by financial institutions and are now a regular component of the business strategies at most institutions. Electronic and Internet delivery of services can have many far-reaching benefits for financial institutions and their customers. In some cases, however, these activities can have implications for a financial institution's financial condition, risk profile, and operating performance.

EXAMINATION APPROACH

In general, examiners should review electronic and Internet banking activities when these services are newly implemented, particularly in institutions that may not have significant experience or expertise in this area or when an institution is conducting novel activities that may pose a heightened risk. Periodic reviews should be conducted thereafter based on any significant changes to the scope of services or nature of the operations, as indicated by an assessment of risk to the institution.

Clearly, electronic and Internet banking concerns could affect an institution's operational-risk profile. Yet, these activities could also affect other financial and business risks, depending on the specific circumstances. Accordingly, examiners should consider an institution's electronic and Internet banking activities when developing risk assessments and supervisory plans. Although electronic and Internet banking may be assessed within the context of an information technology review, the nontechnical aspects of an electronic banking operation should be reviewed and coordinated closely with other examination areas. Rather than conduct detailed technical reviews, examiners should assess the overall level of risk any electronic and Internet banking activities pose to the institution and the adequacy of its approach to managing these risks.

To determine the scope of supervisory activities, close coordination is needed with information technology specialist examiners and consumer compliance examiners during the risk-assessment and planning phase, as well as during on-site examinations. Given the variability of electronic and Internet banking environments, the level of technical expertise required for a particular examination will differ across institutions and should be identified during the planning phase of the examination. When the bank has developed the electronic and Internet banking products or services internally or when a direct connection exists between the institution's electronic and Internet banking systems and its core data processing system, consideration should be given to involving an information technology specialist examiner in the on-site review. The determination of the examination scope should be based on factors such as the following:

- implementation of significant new electronic banking products and services since the last examination
- significant changes in the composition or level of customers, earnings, assets, or liabilities generated or affected by the electronic banking activities
- new or significantly modified systems or outsourcing relationships for activities related to electronic banking
- the need for targeted examinations of business lines that rely heavily on the electronic banking systems or activities
- other potential problems or concerns that may have arisen since the last examination or the need to follow up on previous examination or audit issues

Many resources are available to examiners for reviewing electronic and Internet banking activities. In addition to the procedures in this section, further information can be found in section 4060.1, "Information Technology," and in the *Federal Financial Institutions Examination Council (FFIEC) Information Systems Examination Handbook.* Other federal banking agencies have issued examination guidance relating to electronic and Internet banking, information technology, and information security that may be helpful to examiners in reviewing electronic banking activities. Consumer compliance issues are not addressed in this section.[1]

1. See the Federal Reserve regulations, FFIEC, and other interagency supervisory guidance. See also the FFIEC's "Guidance on Electronic Financial Services and Consumer Compliance" (July 15, 1998), for further information regarding compliance with consumer laws and regulations.

OVERVIEW OF ELECTRONIC BANKING SERVICES

Types of Services

Electronic banking services (including Internet banking services) are designed to provide banking customers with the capability to conduct banking business remotely through personal computers and other electronic devices. Electronic banking comprises personal computer (PC) banking through traditional proprietary communication channels; retail and corporate Internet banking services; telephone banking; and, potentially, other forms of remote electronic access to banking services.

Both large and small institutions offer a variety of Internet-based financial services. Many financial institutions are using the Internet to enhance their service offerings to existing customers. Other organizations may choose to expand their customer base to a wider geographic area by accepting online applications for loan and deposit products. A very small number of banking organizations are focusing on the Internet as their primary delivery channel, whether or not they maintain physical branches.

Current electronic banking products and services typically allow customers to obtain information on bank products and services through the bank's Internet web sites, apply online for new products and services, view loan- and deposit-account balances and transactions, transfer funds between accounts, and perform other banking functions. Most electronic banking services operate using standard Internet browser software installed on the customer's personal computer and do not require that the customer have any additional software or hardware. While electronic banking services have been oriented toward retail customers, many banking organizations offer small-business applications and corporate cash-management services through the Internet. These services typically include payroll, automated clearinghouse (ACH), and wire transfers. Wholesale banking services, which have been conducted electronically for many years, are also beginning to move from proprietary networks and communications channels to the Internet.

Information-only web sites provide the most basic and common form of electronic banking service. Most institutions contract with an Internet service provider (ISP) to provide Internet access and "host," or maintain and operate, the institution's web site. In some cases, the web site is maintained on the institution's own computers (web servers). Even if access to account information is not possible through the web site, institutions may receive e-mail inquiries from customers through their web site.

Transactional Internet banking sites allow customers to obtain online access to their account information and initiate transactions over the Internet. With most Internet banking services, the customer interacts with a stand-alone Internet banking system that has been preloaded with the customer's account balances, transaction history, and other information. Transactions initiated through the Internet banking system are processed by a separate Internet banking application and periodically posted to the institution's general ledger, deposit, and loan accounting systems. Interface or connection with the financial institution's core data processing and accounting systems typically occurs through either (1) a direct connection to the core processing system over a network or (2) a manual download or transfer of transaction data to a diskette or other portable media, which is then uploaded or sent to the core processing system. Most standardized Internet banking software packages now available have been designed with standard interfaces between Internet banking systems and common core-processing systems and software.

Electronic bill-payment services are typically provided to customers as part of most standard electronic banking services. These services generally include capabilities to pay any third party the customer designates, as well as pay companies designated for routine bill payments, such as utilities and credit card issuers. Electronic bill-presentment services, which are much less common, involve the electronic transmission of billing statements to the customer through e-mail or a web site, for subsequent payment through the electronic banking service.

Telephone banking, a fairly conventional form of electronic banking, is provided by many institutions. Telephone banking services generally allow customers to check account balances and transactions and to pay bills through touch-tone or voice-response systems. Banking organizations also offer consumer products and services through wireless devices, such as cellular telephones, pagers, personal digital assistants, handheld computers, or other devices that can provide wireless access to an institution's services, either directly or through the Internet. Account aggregation is a web-based service offered by some financial institutions that consolidates customer-account information from multiple financial or commercial web sites and presents it on a single web site. Aggregated information may include information from financial and nonfinancial accounts held by the customer. Some institutions have established "portals," web sites that link customers to a variety of third-party sites, and alliances with other companies to provide banking or nonbanking services.

Operations

There are a variety of operational methods for providing electronic banking services. Banking organizations may perform their core data processing internally but outsource the Internet banking activities to a different vendor or service provider. A dedicated workstation at the financial institution is often used to transmit transaction data files between the institution's core processing system and the Internet application; the workstation also allows the financial institution to update parameters and perform other maintenance. Alternatively, the service provider for Internet banking may interface directly with the bank's core-processing service provider, if that function is also outsourced. In addition, many banking organizations purchase Internet banking services from their primary core-processing service provider, eliminating the need for external data transmissions. Even with this last structure, the institution maintains a local workstation to provide access to customer information or perform other administrative and maintenance functions for the Internet banking system.

Other institutions operate an electronic banking system in their own computer facilities by purchasing an "off-the-shelf" or turnkey electronic banking software application from a software vendor and then installing the software on their own system. Turnkey options vary from a bank's purchase and use of templates or modules, in which the bank chooses from a selection of standard services, to more complex situations in which the software vendor designs and develops the electronic banking software application to the bank's specifications. Turnkey vendors often provide hardware, software, and ongoing system service and maintenance.

Bill-payment processing is generally conducted through a specialized third-party processor. The payment processor receives payment instructions from the financial institution or the Internet banking service provider, initiates an ACH debit to the account of the customer, and credits the account of the payee. Payments to payees not set up to receive ACH payments, such as individuals and smaller companies, are transmitted by mailing a paper check to the payee.

RISK MANAGEMENT

Board and Management Oversight

Financial institutions commonly implement electronic banking services as a means of delivering existing banking products and services to existing customers. As a result, not all institutions have established a distinct risk-management program for electronic banking. In many cases, policies and procedures for electronic banking activities will be incorporated into existing policies and procedures, such as those governing deposit accounts, payments processing, information security, and lending functions.

Bank management should assess the financial impact of the implementation and ongoing maintenance of electronic banking services. For example, ongoing maintenance and marketing costs of Internet banking operations can be substantial, particularly for smaller banks, depending on the institution's business plan. Bank management should consider the potential impact on the institution's customer base, loan quality and composition, deposit volume, volatility, liquidity sources, and transaction volume, as well as the impact on other relevant factors that may be affected by the adoption of new delivery channels. These areas should be monitored and analyzed on an ongoing basis to ensure that any impact on the institution's financial condition resulting from electronic banking services is appropriately managed and controlled.

In addition, bank management may wish to review periodic reports tracking customer usage, problems such as complaints and downtime, unreconciled accounts or transactions initiated through the electronic banking system, and system usage relative to capacity. Management should also consider the expertise of internal or external auditors to review electronic banking activities and the inclusion of electronic banking activities within audit plans. Insurance policies may need to be updated or expanded to cover losses due to system security breaches, system downtime, or other risks from electronic banking activities.[2]

A change in an institution's business strategy to an Internet-only or Internet-focused operation is generally considered a significant change in business plan.[3] In addition, certain technology operations, such as providing ISP services to the general public, may not be considered permissible banking activities or may be considered permissible by the institution's chartering authority only within certain limitations.

A financial institution should also consider legal ownership of its Internet address (for example, www.bankname.com), also known as its "domain name." Contracts with third-party vendors may specifically address any arrangements to have the third-party vendor register the domain name on behalf of the institution.

Operational and Internal Controls

Web Site Information Maintenance

Because an institution's web site is available on an ongoing basis to the general public, appropriate procedures should be established to ensure the accuracy and appropriateness of its information. Key information changes and updates, such as loan rates, are normally subject to documented authorization and dual verification. Establishing procedures and controls to frequently monitor and verify web site information may help prevent any inadvertent or unauthorized modifications or content, which could lead to reputational damage or violations of advertising, disclosure, or other compliance requirements.

In addition, some institutions provide financial-calculator, financial-management, tax-preparation, and other interactive programs to customers. Institutions may provide online resources for customers to research available options associated with savings products, mortgages, investments, insurance, or other products and services. To protect the institution from potential liability or reputational harm, the bank should test or otherwise verify the accuracy and appropriateness of these tools.

Banks should carefully consider how links to third-party Internet web sites are presented. Hyperlinks to other web pages provide customers with convenient access to related or local information, as well as provide a means for targeted cross-marketing through agreements between the institution and other web site operators. However, such linkages may imply an endorsement of third-party products, services, or information that could lead to implicit liability for the institution. As a result, institutions commonly provide disclaimers when such links take the customer to a third-party web site. Institutions should ensure that they clearly understand any potential liabilities arising out of any cross-marketing arrangements or other agreements with third parties. Any links to sites offering nondeposit investment or insurance products must comply with relevant interagency guidelines.[4] Links to other sites should be verified regularly for their accuracy, functionality, and appropriateness.

Customer Authentication in an Electronic Banking Environment and Administrative Controls

Customer authentication guidance issuances. The federal banking agencies have issued various iterations of examination guidance on authentication in an Internet banking environment to assist examiners with this evolving issue. On August 8, 2001, the FFIEC initially released "Authentication in an Electronic Banking Environment," which reviewed the risks and risk-management controls of authentication tools used to verify the identity of new cus-

2. See section 4040.1, "Management of Insurable Risks," for further information about fraud and computer-related insurance that may be applicable to electronic banking activities.

3. Regulation H sets forth the requirements for membership of state-chartered banks in the Federal Reserve System and imposes certain conditions of membership on applicant banks. A member bank must "at all times conduct its business and exercise its powers with due regard to safety and soundness" and "may not, without the permission of the Board, cause or permit any change in the general character of its business or in the scope of the corporate powers it exercises at the time of admission to membership" (12 CFR 208.3(d)(1) and (2)).

4. See section 4170.3, "Examination Procedures—Retail Sales of Nondeposit Investment Products," and the consumer protection rules for sales of insurance (65 *Fed. Reg.* 75,822 (December 4, 2000)).

tomers and authenticate existing customers. In response to significant legal and technological changes, the FFIEC issued a similarly titled statement on October 12, 2005, which replaced the 2001 guidance. As discussed in this section, the 2005 guidance addressed the need for risk-based assessments, customer awareness, and enhanced security measures to authenticate customers using Internet-based products and services that process high-risk transactions involving access to customer information or the movement of funds to other parties. One of the key points of emphasis of the guidance was that single-factor authentication, as the only control mechanism, is inadequate for high-risk transactions involving access to customer information or the movement of funds to other parties. (See SR-05-19.) To assist the banking industry and examiners, the Board, the FFIEC, and the other federal banking and thrift agencies issued frequently asked questions (FAQs) on August 15, 2006. (See SR-06-13.) The FAQs are designed to assist the financial institutions and their technology service providers in conforming to the guidance by addressing common questions on the scope, risk assessments, timing, and other issues.

On June 29, 2011, the FFIEC released "Supplement to Authentication in an Internet Banking Environment." (See SR-11-9.) The purpose of the 2011 supplement is to reinforce the existing guidance on risk-management framework and update the agencies' expectations regarding customer authentication, layered security, or other controls in the increasingly hostile online environment. The supplement establishes minimum control expectations for certain online banking activities and identifies controls that are less effective in certain situations.

Customer authentication background. Authentication describes the process of verifying the identity of a person or entity. The authentication process is one method used to control access to customer accounts and personal information, and is dependent upon customers providing valid identification data followed by one or more authentication credentials (factors) to prove their identity. Many banks use the same account-opening procedures for electronic applications as they do for mailed or in-person applications. Procedures for accepting electronic account applications generally address areas such as—

- the type of funding accepted for initial deposits;
- funds-availability policies for deposits in new accounts;
- the timing of account-number, check, and ATM-card issuance;
- the minimum customer information required to open new accounts;
- single-factor, tiered single-factor, and multifactor authentication procedures for verification of information provided by the applicant (for example, verifying customer information against credit bureau reports); and
- screening for prior fraudulent account activity, typically using fraud-detection databases.[5]

Strong customer-authentication practices are necessary to help institutions detect and reduce fraud, detect and reduce identity theft, and enforce anti-money-laundering measures. Customer interaction with institutions continues to migrate from physical recognition and paper-based documentation to remote electronic access and transaction initiation. Significant risks potentially arise when an institution accepts new customers through the Internet or other purely electronic channels because of the absence of the physical cues that bankers traditionally use to identify individuals. The risks of doing business with unauthorized or incorrectly identified individuals in an electronic banking environment could result in financial loss and reputation damage.

In addition to limiting unauthorized access, effective authentication provides institutions with the appropriate foundation for electronic agreements and transactions. First, effective authentication provides the basis for the validation of parties to the transaction and their agreement to its terms. Second, authentication is a necessary element to establish the *authenticity* of the records evidencing the electronic transaction if there is ever a dispute. Third, authentication is a necessary element for establishing the *integrity* of the records evidencing the electronic transaction. Because state laws vary, management should involve legal counsel in the design and implementation of authentication systems.

The success of a particular authentication method depends on more than the technology.

5. For information on practices that my help prevent fraudulent account activity, see SR-01-11, "Identity Theft and Pretext Calling."

Success also depends on an institution's having appropriate policies, procedures, and controls. An effective authentication method has the following characteristics: customer acceptance, reliable performance, scalability to accommodate growth, and interoperability with existing systems and future plans. The June 29, 2011, "Supplement to Authentication in an Internet Banking Environment" discusses the effectiveness of certain authentication techniques, namely device identification and the use of challenge questions.

Institutions can use a variety of authentication tools and methodologies to authenticate customers. These tools include the use of passwords and personal identification numbers (PINs), digital certificates using a public key infrastructure (PKI), physical devices such as smart cards or other types of "tokens," database comparisons, and biometric identifiers. The level of risk protection afforded by each of these tools varies and is evolving as technology changes.

Existing authentication methodologies involve three basic "factors":

- something the user *knows* (a password or PIN)
- something the user *possesses* (an ATM card or a smart card)
- something the user *is* (a biometric characteristic, such as a fingerprint or retinal pattern)

Authentication methods that depend on more than one factor typically are more difficult to compromise than single-factor systems. Accordingly, properly designed and implemented multifactor authentication methods are more reliable indicators of authentication and are stronger fraud deterrents. For example, the use of a log-on ID or password is single-factor authentication (something the user knows), whereas a transaction using an ATM typically requires two-factor authentication (something the user possesses—the card—combined with something the user knows—the PIN). In general, multifactor authentication methods should be used on higher-risk systems. Further, institutions should be sensitive to the fact that proper implementation is key to the reliability and security of any authentication system. For example, a poorly implemented two-factor system may be less secure than a properly implemented single-factor system.

Risk assessment. An effective authentication program should be implemented on an enterprise-wide basis to ensure that controls and authentication tools are adequate among all products, services, and lines of business. Authentication processes should be designed to maximize interoperability and should be consistent with the financial institution's overall strategy for electronic banking and e-commerce customer services. The level of authentication a financial institution uses in a particular application should be appropriate to the level of risk in that application.

The implementation of appropriate authentication methods starts with an assessment of the risk posed by the institution's electronic banking systems. The risk-assessment process should

- identify all transactions and levels of access associated with Internet-based customer products and services;
- identify and assess the risk-mitigation techniques, including authentication methodologies, employed for each transaction type and level of access; and
- include the ability to gauge the effectiveness of risk-mitigation techniques for current and changing risk factors for each transaction type and level of access.

The risk should be evaluated in light of the type of customer (retail or commercial), the institution's transactional capabilities (bill payment, wire transfer, or loan origination), the sensitivity and value of the stored information to both the institution and the customer, the ease of using the authentication method, and the size and volume of transactions.

For example, online retail transactions generally involve accessing account information, bill payment, intrabank funds transfers, and occasional interbank funds transfers or wire transfers. Since the frequency and dollar amounts of these transactions are generally lower than commercial transactions, they pose a comparatively lower level of risk. Online commercial transactions generally involve ACH file origination and frequent interbank wire transfers. Since the frequency and dollar amounts of these transactions are generally higher than consumer transactions, they pose a comparatively increased level of risk to the institution and its customer. As such, it is recommended that institutions offer multifactor authentication to their business customers.

The Federal Reserve expects financial institutions to assess the risks to the institution and its customers and to implement appropriate authentication methods to effectively manage risk. Financial institutions should review and update their existing risk assessments as new information becomes available, prior to implementing new electronic financial services, or at least every 12 months. (See *FFIEC IT Examination Handbook*, Information Security Booklet, July 2006, Key Risk Assessment Practices section.) Updated risk assessments should consider, but not be limited to, the following factors:

- changes in the internal and external threat environment (see the attachment to SR 11-9 for more information)
- changes in the customer base adopting electronic banking
- changes in the customer functionality offered through electronic banking
- actual incidents of security breaches, identity theft, or fraud experienced by the institution or industry

A comprehensive approach to authentication requires development of and adherence to corporate standards and architecture, integration of authentication processes within the overall information security framework, risk assessments within the institution's lines of business that support the selection of authentication tools, and a central authority for oversight and risk monitoring. The authentication process should be consistent and support the financial institution's overall security and risk-management programs.

The methods of authentication used in a specific electronic application should be appropriate and "reasonable," from a business perspective, in light of the reasonably foreseeable risks in that application. Because the standards for implementing a commercially reasonable system may change over time as technology and other procedures develop, financial institutions and service providers should periodically review authentication technology and ensure appropriate changes are implemented.

Single-factor authentication tools, including passwords and PINs, have been widely utilized in a variety of retail e-banking activities, including account inquiry, bill payment, and account aggregation. However, not every online transaction poses the same level of risk. Therefore, financial institutions should implement more robust controls as the risk level of the transaction increases. Financial institutions should assess the adequacy of existing authentication techniques in light of changing or new risks (for example, the increasing ability of hackers to compromise less robust single-factor techniques or the risks posed by phishing, pharming, or malware). Financial institutions should no longer rely on one form of customer authentication. A one-dimensional customer authentication program is simply not robust enough to provide the level of security that customers expect and that protects institutions from financial and reputation risk. Instead, multifactor techniques are appropriate for high-risk applications and transactions, which involve access to customer information or the movement of funds to other parties. Institutions should recognize that a single-factor system may be "tiered" to enhance security without implementing a two-factor system. A tiered single-factor authentication system would include the use of multiple levels of a single factor (for example, the use of two or more passwords or PINs employed at different points in the authentication process).

Account origination and customer verification. Institutions need to use reliable methods for originating new customer accounts online. Customer-identity verification during account origination is important in reducing the risk of identity theft, fraudulent account applications, and unenforceable account agreements or transactions. In an electronic banking environment, reliance on traditional forms of paper-based authentication is decreased substantially. Accordingly, financial institutions need to use reliable alternative methods. For example, verification of personal information could include the following:

- *Positive verification* to ensure that material information provided by an applicant matches information available from trusted third-party sources. More specifically, an institution can verify a potential customer's identity by comparing the applicant's answers to a series of detailed questions against information in a trusted database (for example, a reliable credit report) to see if the information supplied by the applicant matches information in the database. As the questions become more specific and detailed, correct answers provide the institution with an increasing level of confidence that the applicants are who they say they are.
- *Logical verification* to ensure that information provided is logically consistent. (For example,

do the telephone area code, ZIP code, and street address match?)
- *Negative verification* to ensure that information provided has not previously been associated with fraudulent activity. For example, applicant information can be compared against fraud databases to determine whether any of the information is associated with known incidents of fraudulent behavior. In the case of commercial customers, however, a sole reliance on online electronic database comparison techniques is not adequate since certain documents needed to establish an individual's right to act on a company's behalf (for example, bylaws) are not available from databases. Institutions must still rely on traditional forms of personal identification and document validation combined with electronic verification tools.

Transaction initiation and authentication of established customers. Once an institution has successfully verified a customer's identity during the account-origination process, it should authenticate customers who wish to gain access to the online banking system. Institutions can use a variety of methods to authenticate existing customers. These methods include the use of passwords, PINs, digital certificates and a PKI, physical devices such as tokens, and biometrics.

Minimizing fraud risk. An institution's policies and procedures should address the management of existing customers' accounts to minimize the risk of fraudulent activity. For example, the customer's ability to expand an existing account relationship through the electronic banking system may warrant added controls, such as sending a separate notification to a customer's physical address when online account access is first requested or when PINs, e-mail addresses, or other key parameters are changed.

To mitigate fraud risk, institutions may establish dollar limits on transactions initiated through the electronic banking application, or they may monitor transactions above specified limits, depending on the type of account (for example, consumer versus corporate). These limits or a similar monitoring system may help detect unusual account activity, which could indicate fraudulent transactions or other suspicious activity.

Funds transfer systems and Internet banking. Any manual interface between the electronic banking system and funds transfer systems, such as capabilities for uploading ACH or Fedwire transactions initiated through the electronic banking system to Fedline terminals, should be subject to system-access controls and appropriate internal controls, such as segregation of duties. Some institutions also permit electronic banking customers to initiate electronic (ACH) debits against accounts held at other institutions; reliable controls to verify that the customer is entitled to draw funds from the particular account are needed if this feature is offered.

Electronic bill-payment services are commonly provided as a component of electronic banking services. The institution should have a direct agreement with bill-payment providers, which may be subcontractors of the provider for the institution's Internet banking services. In this situation, it may be difficult for the institution or its customers to obtain timely and accurate information regarding the status of payment requests. As a result, contracts with service providers that encompass bill-payment services should generally address how payments are made, when payments are debited from a customer account, the treatment of payments when the account has insufficient funds on the settlement date, reconcilement procedures, and problem-resolution procedures.

Even when Internet banking operations are outsourced to a service provider, institutions will generally have access to the electronic banking system through a dedicated desktop computer or workstation. This hardware allows the institution to upload and download transaction information; review transaction logs or audit trails; print daily reports; or, in some cases, reset customer passwords, resolve errors, or respond to customer inquiries. These workstations should be located in secure areas and be subject to normal authorization and access controls and transaction audit trails.

Information Security

Electronic banking activities should be addressed in an institution's information security program, which should include compliance with the federal banking agencies' information security standards.[6] Institutions

6. See section 4060.1 under "Standards for Safeguarding Customer Information" for further details and examination procedures. See also SR-01-25. See also the *FFIEC IT*

need to pay particular attention to the security of customer information, given the heightened security concerns associated with providing access to customer information over the Internet. An institution's written information security policies and procedures should include electronic banking activities. Institutions should implement prudent controls that limit the risk of unauthorized access to key systems, including password-administration controls, firewalls, encryption of sensitive information while it is in transit or being stored, maintenance of all current updates and security patches to software and operating systems, and controls to prevent insider misuse of information. Sound information security practices include procedures and systems to detect changes to software or files, intrusion-detection systems, and security-vulnerability assessments.

Sound information security practices are also based on the concept of layered security, which is the use of different controls at different points in a transaction process so that a weakness in one control is generally compensated for by the strength of a different control. Layered security can substantially strengthen the overall security of Internet-based services and be effective in protecting sensitive customer information, preventing identity theft, and reducing account takeovers and the resulting financial losses. Financial institutions should implement a layered approach to security for high-risk Internet-based systems. Other regulations and guidelines also specifically address financial institutions' responsibilities to protect customer information and prevent identity theft.[7]

Effective controls that may be included in a layered security program include, but are not limited to

- fraud detection and monitoring systems that include consideration of customer history and behavior and enable a timely and effective institution response;
- the use of dual customer authorization through different access devices;
- the use of out-of-band verification for transactions;
- the use of "positive pay," debit blocks, and other techniques to appropriately limit the transactional use of the account;
- enhanced controls over account activities, such as transaction value thresholds, payment recipients, number of transactions allowed per day, and allowable payment windows (e.g., days and times);
- Internet protocol (IP) reputation-based tools to block connection to banking servers from IP addresses known or suspected to be associated with fraudulent activities;
- policies and practices for addressing customer devices identified as potentially compromised and customers who may be facilitating fraud;
- enhanced control over changes to account maintenance activities performed by customers either online or through customer service channels; and
- enhanced customer education to increase awareness of the fraud risk and effective techniques customers can use to mitigate the risk.

At a minimum, an institution's layered security program should (1) detect and respond to suspicious activity and (2) control administrative functions. To detect and respond to suspicious activities, appropriate control processes should be instituted that detect anomalies and effectively respond to suspicious or anomalous activity related to initial login and authentication of customers requesting access to the institution's electronic banking system, as well as the initiation of electronic transactions involving the transfer of funds to other parties. Manual or automated transaction monitoring or anomaly detection and response may prevent instances of ACH/wire transfer fraud since fraudulent wire activities are typically anomalous when compared with the customer's established patterns of behavior.

A layered security program should also control administrative functions. For business accounts, layered security should include enhanced controls for system administrators who are granted privileges to set up or change system configurations, such as setting access privileges and application configurations and/or limitations. These enhanced controls should exceed the controls applicable to routine business customer users. For example, a preventive control could include requiring an additional authenti-

Examination Handbook, Information Security Booklet, July 2006, Key Concept section.

7. See Interagency Final Regulation Guidelines on Identity Theft Red Flags, 12 CFR parts 41, 222, 334, 571, and 717; Interagency Guidelines Establishing Information Security Standards, 12 CFR parts 30, 208, 225, 364, and 570, Appendix B. See also Section 4060.1 under "Identity Theft Red Flags Program" for further details and examination procedures.

cation routine or a transaction verification routine prior to final implementation of the access or application changes. An example of a detective control could include a transaction verification notice immediately following implementation of the submitted access or application changes. Out-of-band authentication, verification, or alerting can be effective controls. Overall, enhanced controls over administrative access and functions can effectively reduce money transfer fraud.

While the technical aspect of information security considerations for electronic banking activities is complex, widely used turnkey software applications for Internet banking generally conform to accepted industry standards for technical security. Detailed assessments of the technical security of specific systems are the responsibility of the institution and its qualified engineers and internal and external auditors. Examiners should focus on the institution's implementation of key security controls for the particular software application.

Any security breaches of an institution's electronic banking service or web site that may lead to potential financial losses or disclosure of sensitive information should be reported to an appropriate management level within the institution. If necessary, the appropriate suspicious-activity report should be filed. Institutions should ensure that their service providers notify them of any computer security breaches in their operations that may affect the institution. Institutions should determine the cause of any such intrusions and develop an appropriate plan to limit any resulting financial losses to the bank and its customers and to prevent recurrence.

Passwords and System-Access Controls

Most institutions use identifiers such as account numbers or ATM card numbers, together with passwords or PINs, to verify the authorization of users accessing the retail electronic banking system. (Wholesale or corporate cash-management systems may use more secure methods, such as smart cards that contain customer credentials, real-time passwords (passwords that can be immediately changed online), or dedicated terminals, to authenticate users.) Prudent password-administration procedures generally require that customer passwords be changed if compromised and that passwords do not automatically default to easily guessed numbers or names. Passwords and PINs are (1) generally encrypted while in transit or storage on insecure networks or computers, (2) suppressed on screen when entered on a keyboard, and (3) suspended after a predetermined number of failed log-in attempts. Institutions should establish clear policies and procedures for retrieving or resetting customer passwords when customers lose or forget their password to minimize the risk that passwords are disclosed to unauthorized individuals.[8]

Firewalls

A firewall is a security control consisting of hardware, software, and other security measures established to protect the bank's internal data and networks, as well as its web sites, from unauthorized external access and use through the Internet. A number of banks and their vendors use various firewall products that meet industry standards to secure their Internet banking services, web sites, and other bank networks. For a firewall to adequately protect a bank's internal networks and systems, it must be properly installed and configured. Firewalls are most effective when all updates and patches to the firewall systems are installed and when the firewall configuration is reassessed after every system change or software update.

Viruses

Computer viruses can pose a threat to information systems and networks that are connected to the Internet. In addition to destroying data and possibly causing system failure, viruses can potentially establish a communication link with an external network, allow unauthorized system access, or even initiate unauthorized data transmission. Widely used protection measures include using anti-virus products that are installed and are resident on a computer or network or providing for virus scanning during downloads of information or the execution of any program. Bank employees and electronic banking customers should be educated about the risks posed to systems by viruses and other malicious programs, as well as about the proper procedures for accessing information to help avoid these threats.

8. See SR-05-19 for further information on password-administration practices.

Encryption of Communications

Information transmitted over the Internet may be accessible to parties other than the sender and receiver. As a result, most retail electronic commerce services use industry-standard secure sockets layer (SSL) technology to encrypt sensitive transactional information between the customer and the web site to minimize the risk of unauthorized access to this information while it is in transit. Although stronger encryption techniques may be warranted for higher-value corporate or wholesale transactions, SSL is generally considered adequate for retail Internet banking transactions.

In addition, many banks accept communications through standard Internet e-mail; in some cases, account applications containing sensitive customer data may be sent to the bank. These communications are generally not protected by SSL or a similar technology but are open to potential unauthorized access. If the electronic banking system does not provide for encrypted e-mail, the bank should ensure that customers (and customer-service representatives) are alerted not to send confidential information by unencrypted e-mail.

Security Testing and Monitoring

Assessments of information security vulnerability, penetration testing, and monitoring help ensure that appropriate security precautions have been implemented and that system security configurations are appropriate. Some institutions contract with third-party security experts to provide these services. Vulnerability assessments provide an overall analysis of system security and report any system vulnerabilities. Such assessments can detect known security flaws in software and hardware, determine system susceptibility to known threats, and identify vulnerabilities such as settings that are contrary to established security policies.

Penetration testing and vulnerability assessments identify an information system's vulnerability to intrusion. Penetration tests examine system security by mimicking external intrusion attempts to circumvent the security features of a system. However, a penetration test is only a snapshot in time and does not guarantee that the system is secure.

Intrusion detection is an ongoing process that monitors the system for intrusions and unusual activities. Intrusion-detection systems, which can be installed on individual computers and at locations on a network, can be configured to alert appropriate system personnel to potential intrusions at the time they occur. In addition, the detection systems provide ongoing reporting and monitoring of unusual events such as potential intrusions or patterns of misuse.

Customer Awareness and Education

Because customer awareness is a key defense against fraud and identity theft, financial institutions should make efforts to educate their customers. Institutions should evaluate their consumer education efforts to determine if additional steps are necessary. The June 29, 2011, "Supplement to Authentication in an Internet Banking Environment" states that financial institution's customer awareness and educational efforts should address both retail and commercial account holders and, at a minimum, include the following elements:

- an explanation of protections provided, and not provided, to account holders relative to electronic funds transfers under Regulation E, and a related explanation of the applicability of Regulation E to the types of accounts with Internet access
- an explanation of under what, if any, circumstances and through what means the institution may contact a customer on an unsolicited basis and request the customer's provision of electronic banking credentials
- a suggestion that commercial online banking customers perform a related risk assessment and controls evaluation periodically
- a listing of alternative risk control mechanisms that customers may consider implementing to mitigate their own risk, or alternatively, a listing of available resources where such information can be found
- a listing of institutional contacts for customers' discretionary use in the event they notice suspicious account activity or experience customer information security-related events

Contingency Planning

Periodic downtime and outages are common with online services. But when the duration or disruption of these outages is significant, it can lead to reputational risk for the institution. For many institutions, short disruptions of electronic banking services may not have a material effect on their operations or customers, as other delivery channels are available. Nevertheless, electronic banking services should be covered by an institution's business-continuity plans. Institutions should assess their disaster-recovery needs by considering the length of time that electronic banking services could be unavailable to customers or for internal processing, and then design backup capabilities accordingly. In some cases, institutions may need to establish the capability to move processing to a different network or data center, or to move electronic banking services to a backup web site.

Typically, the electronic banking system includes capabilities to generate backup files on tapes, diskettes, or other portable electronic media containing key transaction and customer data. Web site information should also be subject to periodic backup. Security and internal controls at backup locations should be as sophisticated as those in place at the primary site. If a bank outsources electronic banking operations to a service provider, the institution should have a full understanding of the service provider's contingency and business-recovery commitments.[9]

Outsourcing Arrangements

Many institutions outsource electronic banking operations to an affiliate or third-party vendor. In addition to operating the Internet banking software application, service providers may provide services such as web site hosting and development, Internet access, and customer service or call-center maintenance. As with other areas of a bank's operations, examiners should evaluate the adequacy of the institution's oversight of its critical service providers.[10]

Banking organizations should consider requiring Internet banking service providers to obtain periodic security reviews performed by an independent party. The client institution should receive reports summarizing the findings.

9. For additional information on business resumption and contingency planning in relation to outsourcing, see section 5300.1, "Information Technology," and the *FFIEC Information Systems Examination Handbook*.

10. See section 5300.1, "Information Technology," and the *FFIEC Information Systems Examination Handbook* for information on risk management for outsourcing arrangements.

1. To develop an understanding of the significance of the bank's electronic banking activities within and across business lines.
2. To assess the types and levels of risks associated with the bank's electronic banking activities.
3. To exercise appropriate judgment when determining the level of review, given the characteristics, size, and business activities of the organization.
4. To assess the current and potential impact of electronic banking activities on the institution's financial profile and condition.
5. To assess the adequacy of risk management and oversight of electronic banking activities, including outsourced activities.
6. To determine if the institution is complying with other applicable laws, rules and regulations.
7. To prepare examination report comments on significant deficiencies and recommended corrective action.
8. To determine the impact, if any, of electronic banking risks on the CAMELS rating, information technology rating, and risk-management ratings.
9. To update the workpapers with any information that will facilitate future examinations.

1. Identify the bank's current and planned electronic banking activities and review the bank's public Internet web sites. Consider whether the bank provides the following types of services:
   a. telephone banking
   b. retail Internet banking services
   c. corporate or wholesale Internet banking services
   d. Internet service provider (ISP)
   e. brokerage services over the Internet
   f. insurance services over the Internet
   g. trust services over the Internet
   h. account aggregation
   i. electronic bill payment
   j. other activities (for example, web portals, financial calculators, cross-marketing arrangements and alliances, or unique services)
2. Review prior examination findings and workpapers related to electronic banking, including consumer compliance, information technology, and other examination areas that may be relevant.
3. Determine if material changes have been made to electronic banking products, services, or operations since the last examination and if any significant changes are planned in the near future.
   a. Ensure the bank has reviewed and updated the existing risk assessment prior to implementing new electronic financial services.
   b. If the bank has not materially changed its electronic banking services, determine if the board or senior management has reviewed the risk assessment within the past 12 months.
4. Determine the significance of the bank's electronic banking activities. Consider the following areas:
   a. approximate percentages and numbers of customers (for example, loan and deposit) that regularly use electronic banking products and services
   b. lending and deposit volumes generated from Internet applications
   c. the current monthly transaction and dollar volume for electronic banking services
   d. costs and fees to operate the system and related services or marketing programs
5. Incorporate an analysis of electronic banking activities into risk assessments, supervisory plans, and scope memoranda, considering the size, activities, and complexity of the organization, as well as the significance of the activities across particular business lines.
6. Assess the level of risk and the current or potential impact of electronic banking activities on the organization's earnings, liquidity, asset quality, operational risk, and consumer compliance. Communicate any concerns to examiners reviewing these areas.
7. Determine if the bank operates its web sites, electronic banking systems, or core data processing systems internally and whether any activities are outsourced to a vendor. If outsourced, all activities should be supported by written agreements that have been reviewed by the bank's legal counsel. Identify the location of the following operations:
   a. design and maintenance of the bank's public web site or home page
   b. computer or server for the bank's public web site
   c. development and maintenance of the bank's electronic banking systems
   d. computer or server for the bank's electronic banking systems
   e. customer service (for example, a call center) for electronic banking services
   f. electronic bill-payment processing or other ancillary services
8. If the bank operates the electronic banking system or core data processing system in-house, review the topology (schematic diagram) of the systems and networks, and determine whether there is a direct, online connection between the bank's core processing systems and the electronic banking system.
9. If the bank operates the electronic banking system or core data processing system in-house, review the transaction-processing flows between the electronic banking system and the bank's core processing systems and identify key control points. Determine

whether information is exchanged in a real-time, batch (overnight), or hybrid-processing mode.

10. Review any available audits or third-party reviews of vendors or service providers the bank uses, such as Service Organization Control Reports (formerly SAS 70 reports).[1] Review any Federal Financial Institutions Examination Council (FFIEC) Shared Application Software Review (SASR) reports or any FFIEC or other supervisory examination reports of service providers that the institution uses.
11. Determine the adequacy of risk management for electronic banking activities (including authentication methods for prospective and existing customers), given the level of risk these activities pose to the institution.[2] Complete or update relevant portions of the electronic banking internal control questionnaire as needed for the specific electronic banking activities identified in the previous steps of these procedures to evaluate the adequacy of—
    a. policies and procedures governing electronic banking activities,
    b. internal controls and security for electronic banking activities,
    c. audit coverage for electronic banking activities,
    d. monitoring and compliance efforts,
    e. vendor and outsourcing management, and
    f. board and management oversight.
12. Determine if the bank engages in any "high-risk" transactions involving access to customer information or the movement of funds to other parties.
    a. If the bank engages in high-risk transactions, ensure the institution has implemented a layered security program and does not rely solely on any single control for authorizing such transactions.[3]
    b. Ensure the bank's layered security program is consistent with the risk for covered consumer and business (commercial) transactions.
13. Perform additional analysis and review, consulting with information technology specialists, consumer compliance specialists, or other subject-matter experts as needed, on areas of potential concern.
14. Determine the impact of any electronic banking activities or internal-control deficiencies on the financial condition of the organization.
15. Determine the extent of supervisory attention needed to ensure that any weaknesses are addressed and that associated risk is adequately managed.
16. Determine the impact of any deficiencies on the CAMELS rating, information technology rating, operational-risk rating, and any other relevant supervisory ratings.
17. Prepare comments for the examination report on any significant deficiencies and recommended corrective action.
18. Update the workpapers with any information that will facilitate future examinations.

1. Effective June 15, 2011, the Statement on Standards for Attestation Engagements (SSAE) No. 16, "Reporting on Controls at a Service Organization," replaces the guidance for service auditors in the American Institute of Certified Public Accountants (AICPA) Statement of Auditing Standards (SAS) No. 70 "Service Organizations."

2. See SR-05-19, "FFIEC Guidance on Authentication in an Internet Banking Environment," and SR-11-19, "Interagency Supplement to Authentication in an Internet Banking Environment."

3. See SR-11-9 and Section 4063.1.

Review the bank's internal controls, policies, practices, and procedures for electronic banking activities. Complete those questions necessary to assess whether any potential concerns warrant further review.

POLICIES AND PROCEDURES

1. Are updates and changes to the bank's public web sites—
   a. made only by authorized staff?
   b. subject to dual verification?
2. Are web site information and links to other web sites regularly verified and reviewed by the bank for—
   a. accuracy and functionality?
   b. potential reputational, compliance, and legal risk?
   c. appropriate disclaimers?
3. Do operating policies and procedures include—
   a. procedures for and controls over the opening of new customer accounts submitted through electronic channels in order to verify potential customer identity and financial condition?
   b. single-factor and tiered single-factor or multifactor procedures for authenticating the identity of prospective and existing customers when administering access to the electronic banking system (for example, customer passwords, personal identification numbers (PINs), or account numbers)?
   c. requirements for review of or controls over wire transfers or other large transfers initiated through the electronic banking system, to watch for potentially suspicious activity?
   d. appropriate authorizations for electronic debits initiated against accounts at other institutions, if such transfers are allowed?
   e. depending on the type of account, dollar limits on transactions over a given time period initiated through the electronic banking service?
   f. reconcilement and accounting controls over transactions initiated through the electronic banking system, including electronic bill-payment processing?
4. Do written information security policies and procedures address electronic banking products and services?
5. Are business-recovery procedures adequate? Do the procedures address—
   a. events that could affect the availability of the electronic banking system, such as system outages, natural disasters, or other disruptions?
   b. planned recovery times that are consistent with how important electronic banking activities are to the institution?
6. Has management established an adequate incident-response plan to handle and report potential system security breaches, web site disruptions, malicious tampering with the web site, or other problems?

AUDIT AND INDEPENDENT REVIEW

1. Do the bank's internal and external audit programs address electronic banking activities and systems?
2. Is the level of audit review commensurate with the risks in electronic banking activities and systems?
3. Do audits address—
   a. the review and testing of the bank's internal controls relating to electronic banking?
   b. the review of service-provider performance relative to contract terms, if services are outsourced?
   c. the review of the service providers' internal or external audits or third-party reviews, if services are outsourced?
4. Is management's response to any audit recommendations timely and appropriate?

INTERNAL CONTROLS AND SECURITY

1. Has the bank or service provider implemented a firewall to protect the bank's web site?
2. Are ongoing monitoring and maintenance arrangements for the firewall in place to ensure that it is properly maintained and configured?

3. If the bank uses a turnkey electronic banking software package or outsources to a service provider—
   a. are bank staff familiar with key controls detailed by the vendor's security and operating manuals and training materials?
   b. are workstations that interface with the service provider's system for administrative procedures or for the transfer of files and data kept in a secure location with appropriate password or other access control, dual-verification procedures, and other controls?
4. Does the bank's control of customer access to the electronic banking system include—
   a. procedures to ensure that only appropriate staff are authorized to access electronic banking systems and data, including access to any workstations connected to a remote system located at a service provider?
   b. levels of authentication methods that are commensurate with the level of risk in the bank's electronic banking applications?
   c. the length and composition of passwords and PINs?
   d. encryption of passwords and PINs in transit and storage?
   e. the number of unsuccessful log-on attempts before the password is suspended?
   f. procedures for resetting customer passwords and PINs?
   g. automatic log-off controls for user inactivity?
5. Have security-vulnerability assessments and penetration tests of electronic banking systems been conducted? Has the bank reviewed the results?
6. Has the bank or its service provider established—
   a. an intrusion-detection system for electronic banking applications?
   b. procedures to detect changes in electronic banking files and software?
   c. measures to protect the electronic banking system from computer viruses?
   d. procedures for ensuring on an ongoing basis that electronic banking applications, operating systems, and the related security infrastructure incorporate patches and upgrades that are issued to address known security vulnerabilities in these systems?
7. If e-mail is used to communicate with customers, are communications encrypted or does the bank advise customers not to send confidential information through e-mail?

MONITORING AND COMPLIANCE

1. Are adequate summary reports made available to management to allow for monitoring of—
   a. web site usage?
   b. transaction volume?
   c. system-problem logs?
   d. exceptions?
   e. unreconciled transactions?
   f. other customer or operational issues?
2. Has management established adequate procedures for monitoring and addressing customer problems with electronic banking products and services?
3. Does management accurately report its primary public web-site address on its Consolidated Report of Condition and Income?
4. Have required Suspicious Activity Reports involving electronic banking, including any computer intrusions, been filed? See the requirements for suspicious-activity reporting in section 208.62 of the Board's Regulation H (12 CFR 208.62), and the Bank Secrecy Act compliance program in section 208.63 (12 CFR 208.63).

VENDORS AND OUTSOURCING

1. Is each significant vendor, service provider, consultant, or contractor relationship that is involved in the development and maintenance of electronic banking services covered by a written, signed contract? Depending on the nature and criticality of the services, do contracts specify—
   a. minimum service levels and remedies or penalties for nonperformance?
   b. liability for failed, delayed, or erroneous transactions processed by the service provider and for other transactions in which losses may be incurred (for example, insufficient funds)?
   c. contingency plans, recovery times in the event of a disruption, and responsibility for backup of programs and data?

   d. data ownership, data usage, and compliance with the bank's information security policies?
   e. bank access to the service provider's financial information and results of audits and security reviews?
   f. insurance to be maintained by the service provider?
2. Has legal counsel reviewed the contracts to ensure they are legally enforceable and that they reasonably protect the bank from risk?
3. Has the bank ensured that any service provider responsible for hosting or maintaining the bank's web site has implemented—
   a. controls to protect the bank's web site from unauthorized alteration and malicious attacks?
   b. procedures to notify the bank in the event of such incidents?
   c. regular backup of the bank's web site information?
4. Depending on the nature and criticality of the services, does the bank conduct initial and periodic due-diligence reviews of service providers, including—
   a. reviewing the service provider's standards, policies, and procedures relating to internal controls, security, and business contingency to ensure they meet the bank's minimum standards?
   b. monitoring performance relative to service-level agreements and communicating any deficiencies to the service provider and to bank management?
   c. reviewing reports provided by the service provider on response times, availability and downtime, exception reports, and capacity reports, and communicating any concerns to bank management and the vendor?
   d. periodically reviewing the financial condition of the service provider and determining whether backup arrangements are warranted as a result?
   e. reviewing third-party audits, SAS 70 reports, and regulatory examination reports on the service provider, if available, and following up on any findings with the service provider?
   f. conducting on-site audits of the service provider, if appropriate based on the level of risk?
   g. participating in user groups?
   h. ensuring the bank's staff receives adequate training and documentation from the vendor or service provider?
5. If the bank operates a turnkey electronic banking software package—
   a. is software held under an escrow agreement?
   b. has the bank established procedures to ensure that relevant program files and documentation held under the software escrow agreement are kept current and complete?
6. If a vendor maintains the bank's electronic banking system, does the bank monitor the on-site or remote access of its systems by the vendor, through activity logs or other measures?

BOARD AND MANAGEMENT OVERSIGHT

1. Does the board or an appropriate committee approve the introduction of new electronic banking products and services on the basis of a written business plan and risk analysis that are commensurate with the proposed planned activity?
2. Has the bank considered—
   a. whether the service is designed to provide information on existing services to existing customers or to attract new customers?
   b. whether financial incentives will be offered to attract customers through the electronic banking service? What is the financial impact of such incentives on the bank?
   c. the potential impact of electronic banking products and services on the composition of the bank's customer base?
   d. the projected financial impact of the new service, including up-front and operating costs and any impact on fees or other revenue or expenses?
   e. internal controls appropriate for the new product or service?
   f. whether adequate management reports are provided and subject to periodic review?
   g. whether any new nonbanking activities are permissible under applicable state and federal banking laws?

h. the extent of outsourcing and responsibilities for managing vendor and service-provider relationships?

3. Has the bank evaluated the adequacy of its insurance coverage to cover operational risks in its electronic banking activities?
4. Has the bank's legal counsel been involved in the development and review of electronic banking agreements (for example, agreements with third-party vendors)? Has the bank's legal counsel also been involved in the development and review of its authentication methods to ensure that the methods provide a foundation to enforce agreements and transactions and to validate the parties involved, consistent with applicable state laws?

INTRODUCTION

Modern economies require an efficient system for transferring funds between financial institutions and between financial institutions and their customers. Banks and other depository institutions use payment systems both to transfer funds related to their own operations—for example, when engaging in federal-funds transactions—and to transfer funds on behalf of their customers. Depository institutions and the Federal Reserve together provide the basic infrastructure for the nation's payment system.

Commercial banks maintain accounts with each other and with the Federal Reserve Banks; through these accounts, the payments of the general public are recorded and ultimately settled. The demand for electronic funds transfer (EFT) services has increased with improved data communication and computer technology. Community banks that previously executed EFT transactions through a correspondent can now initiate their own same-day settlement transactions nationwide. The need for same-day settlement transactions has precipitated financial institutions' increased reliance on EFT systems. Financial institutions commonly use their EFT operations to make and receive payments, buy and sell securities, and transmit payment instructions to correspondent banks worldwide. In the United States, most of the dollar value of all funds transfers is concentrated in two electronic payment systems: the Fedwire Funds Service, which is a real-time gross settlement system provided by the Federal Reserve Banks, and the Clearing House Interbank Payments System (CHIPS), which is a private-sector multilateral settlement system owned and operated by the Clearing House Payments Company.

Final settlement occurs when payment obligations between payment-system participants are extinguished with unconditional and irrevocable funds. For transactions settled in physical currency, payment and settlement finality occur simultaneously. On occasion, settlement finality may not occur on the same day a payment is made. Without immediate settlement finality, the recipient of a payment faces the uncertainty of not receiving the value of funds that has been promised. The exposure to this uncertainty is generally referred to as *payment system risk* (PSR).

Payment system risk refers to the risk of financial loss to the participants in, and operators of, payment systems due to a variety of exposures, such as counterparty or customer default, operational problems, fraud, or legal uncertainty about the finality of settled payments. A major source of payment system risk arises when participants in, or the operator of, a payment system extends unsecured, intraday credit to facilitate the smooth and efficient flow of payments. For example, the aggregate value of intraday credit extended by the Federal Reserve, in the form of daylight overdrafts in institutions' Federal Reserve accounts, is substantial and creates significant credit exposure for the Federal Reserve Banks.

A daylight overdraft occurs whenever an institution has a negative account balance during the business day. Such a credit exposure can occur in an account that an institution maintains with a Federal Reserve Bank or with a private-sector financial institution. At a Reserve Bank, a daylight overdraft occurs when an institution has insufficient funds in its Federal Reserve account to cover Fedwire funds transfers, incoming book-entry securities transfers, or other payment activity processed by the Reserve Bank, such as automated clearinghouse or check transactions. Similarly, banks are exposed to credit risk when they permit their customers to incur daylight overdrafts in their accounts. More specific information about the types of risks involved under the rubric of payment systems risk is discussed later in this section.

When developing an institution's overview, performing annual and quarterly risk assessments, and conducting the institution's examination, examiners should review an institution's payment system risk and EFT practices. Supervisory and examination guidance and procedures should be followed to determine the risk assessment, matrix, supervisory plan, and scope of an examination. This guidance should also be used when conducting the examination. An overall initial analysis of an institution's payment system risk practices can provide examiners with quick insight on the adequacy of its current internal controls and risk-management practices, and on whether the institution's payment activity creates intraday exposures that may pose significant risk if not managed properly.

In general, examiners should review the frequency, magnitude, and trend of daylight overdrafts in an institution's Federal Reserve account, as well as any breaches of its net debit cap. Examiners should analyze the reasons for the daylight overdrafts and cap breaches; the nature of the transactions causing the overdrafts (for example, correspondent check clearings or funds transfers); whether the number of customers, correspondents, and respondents is concentrated among only a few entities; whether there is a clear pattern of transactions; and the types of activities involved. In addition, examiners should review and determine the adequacy of the resolution by the board of directors authorizing the institution's net debit cap and use of Federal Reserve intraday credit (as required by the PSR policy). The examiners' most important goal is to ensure that banks have and use appropriate risk-management policies and procedures that effectively monitor and control their exposure to payment system risk.

POLICY ON PAYMENT SYSTEM RISK

The Board of Governors of the Federal Reserve recognizes that the Federal Reserve has an important role in providing intraday balances and credit to foster the smooth operation of the payment system. The Reserve Banks provide intraday balances by way of supplying temporary, intraday credit to healthy depository institutions, predominantly through collateralized intraday overdrafts.

The Policy on Payment System Risk (PSR policy) governs the provision of intraday credit, or daylight overdrafts, to healthy depository institutions with accounts at the Federal Reserve Banks. The PSR policy is intended to foster the safety and efficiency of payment and settlement systems. The PSR policy contains three parts. Part II governs the provision of daylight overdrafts in accounts at the Reserve Banks.

Comprehensive information about payment system risk and the PSR policy is available on the Board's website.

- Payment Systems Risk (includes the most recent version of the PSR policy)
- Payment Systems Risk: Related Policy Documents
- Daylight Overdrafts and Fees

TYPES OF PAYMENT SYSTEMS

An understanding of the mechanics of the various payment systems is necessary to evaluate the operational procedures depository institutions use to control payment-processing risks for their own or their customers' accounts.

Funds Transfer Systems

Fedwire Funds Service

The Fedwire funds-transfer system is a real-time gross settlement system in which depository institutions initiate funds transfers that are immediate, final, and irrevocable when processed. Depository institutions that maintain a master account with a Federal Reserve Bank may use Fedwire to directly send or receive payments to, or receive payments from, other account holders directly. Depository institutions use Fedwire to handle large-value and time-critical payments, such as payments for the settlement of interbank purchases and sales of federal funds; the purchase, sale, and financing of securities transactions; the disbursement or repayment of loans; and the settlement of real estate transactions.

In the Fedwire funds-transfer system, only the originating financial institution can remove funds from its Federal Reserve account. Originators provide payment instructions to the Federal Reserve either online or offline. Online participants send instructions through a mainframe or PC connection to Fedwire, and no manual processing by the Federal Reserve Banks is necessary. Offline participants give instructions to the Reserve Banks by telephone. Once the telephone request is authenticated, the Reserve Bank enters the transfer instruction into the Fedwire system for execution. The manual processing required for offline requests makes them more costly; thus, they are suitable only for institutions that have small, infrequent transfers. (For further information, see https://www.federalreserve.gov/paymentsystems.)

CHIPS

The Clearing House Interbank Payments System (CHIPS) is a large-value funds-transfer system for U.S. dollar payments between domestic or foreign banks that have offices located in the United States. CHIPS provides a final intraday settlement system, continuously matching, netting, and settling queued payment orders throughout the business day.

All CHIPS payment orders are settled against positive balances and are simultaneously offset by incoming payment orders, or some combination of both. To facilitate this process, the funding participants jointly maintain an account (CHIPS account) on the books of the Federal Reserve Bank of New York. Each CHIPS participant must fund this account via a Fedwire funds transfer to fulfill its pre-funded opening-position requirement. These required balances are then used to settle payment orders throughout the day.

During the operating day, participants submit payment orders to a centralized queue maintained by CHIPS. Payment orders that do not pass certain settlement conditions are held in the central queue until an opportunity for settlement occurs or until the end-of-day settlement process. The sending and receiving participants are not obligated to settle these queued payment orders.

Each afternoon, each participant with a closing-position requirement must transfer, through Fedwire, its requirement to the CHIPS account at the Federal Reserve Bank of New York.[1] These requirements, when delivered, are credited to participants' balances at CHIPS. After completion of this process, CHIPS will transfer to those participants who have any balances remaining, that is, participants in an overall net positive position for the day, the full amount of those positions.

Manual Systems

Not all financial institutions employ an EFT system. Some banks execute such a small number of EFT transactions that the cost of a computer-based system such as Fedwire is prohibitive. Instead, these banks will continue to execute EFTs by a telephone call to a correspondent bank. Executing EFT transactions in this way is an acceptable practice as long as the bank has adequate internal control procedures.

1. Although CHIPS no longer makes distinctions between settling and nonsettling participants, CHIPS participants can use nostro banks to make transfers on their behalf.

Message Systems

The message systems employed by financial institutions, corporations, or other organizations to originate payment orders—either for their own benefit or for payment to a third party—are indispensable components of funds-transfer activities. Unlike payment systems, which transmit actual debit and credit entries, message systems process administrative messages and instructions to move funds. The actual movement of the funds is then accomplished by initiating the actual entries to debit the originating customer's account and to credit the beneficiary's account at one or more financial institutions. If the beneficiary's account or the beneficiary bank's account is also with the originator's bank, the transaction is normally handled internally through *book entry.* If the beneficiary-related accounts are outside the originating customer's bank, the transfer may be completed by use of a payment system such as Fedwire or CHIPS. The means of arranging payment orders ranges from manual methods (for example, memos, letters, telephone calls, fax messages, or standing instructions) to electronic methods using telecommunications networks. These networks may include those operated by the private sector, such as SWIFT or Telex, or other networks operated internally by particular financial institutions.

Even though the transfers initiated through systems such as SWIFT and Telex do not result in the immediate transfer of funds from the issuing bank, they do result in the issuing bank's having an immediate liability, which is payable to the disbursing bank. Therefore, the internal operating controls of these systems should be as stringent as the ones implemented for systems such as Fedwire and CHIPS.

SWIFT

The Society for Worldwide Interbank Financial Telecommunications (SWIFT) is a nonprofit cooperative of member banks that serves as a worldwide interbank telecommunications network for structured financial messaging. Based in Brussels, Belgium, SWIFT is the primary system employed by financial institutions worldwide to transmit either domestic or international payment instructions. (For further information, see https://www.swift.com.)

Automated Clearinghouse and Check Transactions

The automated clearinghouse (ACH) is an electronic payment delivery system used to process low-dollar retail payments. The system is used for preauthorized recurring payments and one-time payments. First introduced in the early 1970s as a more efficient alternative to checks, ACH has evolved into a nationwide mechanism that processes electronically originated credit and debit transfers for any participating institution nationwide. An alternative to paper checks, the ACH handles billions of payments annually.

Financial institutions are encouraged to obtain a copy of the ACH rules of the National Automated Clearing House Association (NACHA): *A Complete Guide to Rules and Regulations Governing the ACH Network.* The ACH rules provide detailed information on rule changes, their operational impact, and whether any software changes are required. The rulebook is designed to help financial institutions comply with the current NACHA rules, which are applicable to all ACH participants and include a system of national fines. (For further information, see www.nacha.org.)

The Federal Reserve ACH is governed by Operating Circular #4, "Automated Clearing House Items." Other important federal legislation concerning the ACH can be found in Regulation E (primarily regarding consumer rights pertaining to electronic funds transfers) and Regulation CC (concerning the availability of funds). (For further information, see www.frbservices.org.)

There are two types of ACH transactions: ACH debits and ACH credits. In an ACH debit transaction, the originator of the transaction is debiting the receiver's account. Therefore, funds flow from the receiver to the originator of the transaction. Mortgage payments for which consumers authorize the mortgage company to debit their accounts each month are examples of ACH debit transactions. ACH debits are also being used increasingly for one-time payments authorized through the telephone, Internet, or mail.

ACH debit transactions have similarities to check transactions. Both receivers of ACH debit files and payers of checks have the right to return transactions for various reasons, such as insufficient funds in the account or a closed account. The major risk facing institutions that originate ACH debit transactions and collect checks for customers is return-item risk. Return-item risk extends from the day funds are made available to the customer until the individual return items are received.

In an ACH credit transaction, the originator of the transaction is crediting the receiver's account. An ACH credit transaction is similar to Fedwire funds transfers in that funds flow from the originator of the transaction to the receiver. A company payroll payment to its employee would be an example of an ACH credit transaction: the bank sending payments on behalf of a customer (the employer in this instance) has a binding commitment to settle for the payments when the bank sends them to the ACH operator. Since the ACH is a value-dated mechanism, that is, transactions may be originated one or two days before the specified settlement day, the bank is exposed to temporal credit risk that may extend from one to three business days, depending on when the customer (the employer) funds the payments it originates. If the customer fails to fund the payments on the settlement day, the potential loss faced by the originating bank is equal to the total value of payments from the time the payments are sent to the ACH operator until the customer funds these payments.

SECURITIES CLEARING AND SETTLEMENT SYSTEMS

Fedwire Securities

The Fedwire Securities Service is a securities settlement system that provides safekeeping services and transfer and settlement services. The safekeeping services enable eligible participants to hold securities issued by the U.S. Department of the Treasury, federal agencies, government-sponsored enterprises (GSEs), and certain international organizations in securities accounts at the Reserve Banks. The transfer and settlement services enable eligible participants to transfer securities to other eligible participants against payment or free of payment.

Participants in the Fedwire Securities Service generally maintain a master account and have routine access to Reserve Bank intraday credit. Like the Fedwire Funds Service, access to the Fedwire Securities Service is limited to depository institutions and a few other organizations, such as federal agencies, state government treasurers' offices (which are designated by the U.S.

Department of the Treasury to hold securities accounts), and limited-purpose trust companies that are members of the Federal Reserve System. Nonbank brokers and dealers typically hold and transfer their securities through clearing banks, which are Fedwire participants that provide specialized government securities clearing services. (For more information, see www.federalreserve.gov/paymentsystems/)

Securities transfers can be made free of payment or against a designated payment. Most securities transfers involve the delivery of securities and the simultaneous exchange of payment for the securities, a transaction called delivery-versus-payment. The transfer of securities and related funds (if any) is final at the time of transfer.

Transfer-Size Limit on Book-Entry Securities

Secondary-market book-entry securities transfers on Fedwire are limited to a transfer size of $50 million par value. This limit is intended to encourage partial deliveries of large trades in order to reduce position building by dealers, a major cause of book-entry securities overdrafts before the introduction of the transfer-size limit and daylight-overdraft fees. This limitation does not apply to—

- original-issue deliveries of book-entry securities from a Reserve Bank to an institution, or
- transactions sent to or by a Reserve Bank in its capacity as fiscal agent of the United States, government agencies, or international organizations.

Thus, requests to strip or reconstitute Treasury securities or to convert bearer or registered securities to or from book-entry form are exempt from this limitation. Also exempt are pledges of securities to a Reserve Bank as principal (for example, discount window collateral) or as agent (for example, Treasury Tax and Loan collateral).

Private Systems

In addition to U.S. Treasury and government-agency securities, major categories of financial instruments commonly traded in the United States include corporate equities and bonds, municipal (state and local) government securities, money market instruments, and derivatives such as swaps and exchange-traded options and futures. These instruments are generally traded through recognized exchanges or over-the-counter dealer markets. The mechanisms for clearance and settlement vary by type of instrument and generally involve specialized financial intermediaries, such as clearing corporations and depositories. Clearing corporations provide trade comparison and multilateral netting of trade obligations. Securities depositories, in contrast, hold physical securities and provide book-entry transfer and settlement services for their members.

The vast majority of corporate equity and bond trades are cleared through the National Securities Clearing Corporation (NSCC). Most corporate securities, as well as municipal government bonds, are held at the Depository Trust Company (DTC) in New York. Settlement of securities cleared through the NSCC is effected by book-entry transfers at the DTC. The DTC and the NSCC are owned by the Depository Trust and Clearing Corporation, an industry-owned holding company. (For more information, see www.dtcc.com.)

U.S. Treasury, federal-agency, and mortgage-backed securities are generally traded in over-the-counter markets. The Fixed Income Clearing Corporation (FICC) compares and nets its members' trades in most U.S. Treasury and federal-agency securities. The FICC relies on the Fedwire securities service, discussed above, to effect final delivery of securities to its participants. The FICC is owned by the DTCC. (For more information see www.dtcc.com.)

The FICC also provides automated post-trade comparison, netting, risk-management, and pool-notification services to the mortgage-backed securities market. The FICC provides its specialized services to major market participants active in various Government National Mortgage Association (GNMA), Federal Home Loan Mortgage Corporation (Freddie Mac or FHLMC), and Federal National Mortgage Association (Fannie Mae or FNMA) mortgage-backed securities programs. The net settlement obligations of FICC participants are settled through the Fedwire book-entry securities system.

ELECTRONIC FUNDS TRANSFER ACTIVITIES

EFT MANAGEMENT

Economic and financial considerations have led financial institutions and their customers to recognize the need to manage cash resources more efficiently. The PSR policy calls on private networks and institutions to reduce their own credit and operational risks. It also depends on the role of the Federal Reserve and other financial institution regulators in examining, monitoring, and counseling institutions. To ensure that banking institutions are following prudent banking practices in their funds-transfer activities, examinations should focus equally on the evaluation of credit, liquidity, and operational risks.

The bank should establish guidelines for types of allowable transfers. Procedures should be in effect to prevent transfers drawn against uncollected funds. Thus, banks should not transfer funds against simple ledger balances unless preauthorized credit lines have been established for that account.

Errors and omissions, as well as the fraudulent alteration of the amount of a transfer or of the account number to which funds are to be deposited, could result in losses to the bank. Losses may include total loss of the transferred funds, loss of availability of funds, interest charges, and administrative expenses associated with the recovery of the funds or correction of the problem.

Management is responsible for assessing the inherent risks in the EFT system, establishing policies and controls to protect the institution against unreasonable exposures, and monitoring the effectiveness of safeguards. Regulatory agencies will ensure that each financial institution has evaluated its own risks realistically and has adequate accounting records and internal controls to keep exposures within reasonable, established limits.

The risks associated with any computerized EFT system can be reduced if management implements the controls that are available on the system. For example, the authority to enter, verify, and send transfers can be segregated, and the dollar amount of transactions can be limited. Effective risk management requires that management establish and maintain—

- reasonable credit limits (payments in excess of these limits that involve significant credit risk must be properly approved by appropriate lending authorities),
- adequate recordkeeping to determine the extent of any intraday overdrafts and potential overnight overdrafts before releasing payments, and
- proper monitoring of respondents' accounts when the institution sets the positions of others. Responsibility for this function should be assigned to an appropriate supervisory level of management that will ensure the use of adequate internal controls.

Authentication or Verification Methods

The same due care that financial institutions use when executing EFT transactions must be used when accepting EFT requests from customers. Management must implement security procedures for ensuring that the transfer requests are authentic. As stated in Uniform Commercial Code (UCC) section 4A-201, "Authorized and Verified Payment Orders," security procedures may require the use of algorithms or other codes, identifying words, or numbers; encryption; callback procedures; or similar security devices. An explanation of authorized and verified payment orders is detailed in UCC section 4A-202.

Signature Verification

One method to verify the authenticity of a customer's EFT request is to verify the customer's signature. Unfortunately, this procedure cannot be performed when the customer requests the transaction by telephone. Some financial institutions have implemented policies whereby the customer completes and signs a transfer request, and then faxes the request to the bank. However, this is not a safe EFT procedure because, although the bank can verify the signature on the faxed request, it cannot be certain that the transfer request is legitimate. Any document that is transmitted electronically can be altered (for example, by changing the amount or account number). The alteration can occur before the document is digitalized (that is, before being fed into the fax machine) or after. In most instances, these alterations cannot be detected by the receiving entity. If there is any question about a document's authenticity, the transaction should be reconfirmed through other sources.

Personal Identification Numbers

One way for financial institutions to authenticate transfers initiated over the telephone is through the use of personal identification numbers (PINs) issued to each customer. When a customer requests a transfer, his or her identity is verified by comparing the supplied PIN with the customer's PIN-request form that is on file. At a minimum, the following safeguards should be implemented for these types of transfers:

- All nonretail customers should be requested to sign an agreement whereby the bank is held harmless in the event of an unauthorized transfer if the bank follows routine authentication procedures. The customer is responsible for informing the bank about changes in who is authorized to execute EFTs. These procedures should minimize the risk to the bank if someone is able to execute a fraudulent transaction. (These procedures are described in detail in UCC section 4A-202.)
- All transactions over a specific dollar amount should be re-verified by a callback routine. The bank should require that the person being called for re-verification is someone other than the person who initially requested the transaction.
- Whenever new PINs are issued, they should be mailed in sealed, confidential envelopes (preferably computer-generated) by someone who does not have the ability to execute wire transfers.
- The number of bank employees who have access to PINs should be very limited.

Tape Recording

The tape recording of EFT requests made over the telephone is another internal control practice. When possible, verifying and recording the incoming telephone number (that is, using a caller-ID system) is also a good practice. The laws addressing telephone recording vary by state. Some states require that the caller be informed that the conversation is being recorded; others do not have this requirement. Regardless of the state's law, the bank should inform callers that, for their protection, conversations are being recorded. Moreover, banks should have in place a policy for archiving the taped telephone records and should retain them for a specified period of time, at least until the statements from the Federal Reserve or correspondent banks have been received and reconciled.

Statements of Activity

Some larger banks have implemented a procedure whereby customers are electronically sent a summary statement at the end of each day. The statement lists the transfers executed and received on their behalf. The statement can be sent through a fax machine, a personal computer, or a remote printer. This procedure quickly identifies any transfers the customer did not authorize.

Test Keys

EFT requests can be authenticated using *test keys.* A test key is a calculated number that is derived from a series of codes that are contained in a test-key book. The codes in a test-key book represent such variables as the current date, hour of the day, receiving institution, receiving account number, and amount of the transfer. The value derived from these variables equals the test key. The financial institution or corporate customer initiating the transfer will give its EFT information, along with the test-key value. The receiving bank will recalculate the test key and, if the two test keys equal the same amount, the EFT request is considered authenticated. Test-key code books should be properly secured to prevent unauthorized access or fraudulent use. The use of test keys has declined in recent years as more and more institutions implement PC-based EFT systems.

Blanket Bond

Although computer-related employee misappropriations are normally covered, financial institution blanket bond policies generally exclude certain types of EFT activities from standard coverage. Separate coverage for EFT systems is available and should be suggested to management, particularly if a significant risk exposure exists. A bank's fidelity bond insurance could be declared null and void by the carrier if a fraudulent transfer were to occur and the loss was directly attributable to weak internal controls. (See section 4040.1, "Management of Insurable Risks.")

SUPERVISORY RISK EVALUATION

Bank management is responsible for assessing the inherent risks in the EFT system (or systems) it uses. Management should establish policies and controls to protect the institution against unreasonable exposures, as well as monitor the effectiveness of the established safeguards.

Examiner Responsibilities

Examiners are responsible for ensuring that financial institutions have assessed and evaluated their risks realistically and have adopted internal controls that are adequate to keep those risks within acceptable limits. The types of risks involved in EFT systems, as well as payment systems generally, are discussed below.

Credit Risk

Credit risk is the risk that a counterparty will not settle an obligation for full value when due, nor at any time subsequently. Any time an institution extends credit to a customer or permits a customer to use provisional funds to make a payment, the institution is exposed to the risk that the customer will not be able to meet its payment obligation. If the customer is unable or unwilling to repay the credit extension, the institution could incur a financial loss. Similarly, an institution that receives a payment in provisional funds has a credit exposure to the sender until such time as the payment is settled with finality, that is, until the payment becomes unconditional and irrevocable. If an institution permits a customer to withdraw or make a payment with provisional funds received, then the institution incurs credit exposure to both the sender of the provisional funds and the customer. Those credit exposures are not extinguished until the provisional funds received are settled with finality. With respect to payment systems risk, overall credit risk consists of (1) direct-credit risk to the Federal Reserve, that is, a borrowing institution may be unable to cover its intraday overdraft arising from a transfer of funds or receipt of book-entry securities, thus causing a Federal Reserve Bank to incur a loss; (2) private direct-credit risk, or the possibility of loss to institutions extending credit; and (3) systemic risk, which is the possibility of loss to multiple creditors when borrowing institutions fail to cover their obligations to creditor institutions. Variants of credit risk include sender risk, receiver risk, and return-item risk.

Systemic risk. Stated more clearly, systemic risk occurs when one participant in a payment system, or in the financial markets generally, fails to repay its required obligation when due, and this failure prevents other private or market participants or financial institutions from meeting their settlement obligations when due. Systemic risk may result from extraneous events, actions, or reasons that are independent of the institution, or from developments in the payment system. Changes in the capital markets, domestic political or government announcements or actions, unplanned events, or sovereign actions of other countries are examples of events that may cause systemic risk.

Sender risk. Sender risk is the risk that results if a depository institution uses an extension of credit to make an irrevocable payment on behalf of a customer. This credit can be a loan or an extension of payment against uncollected or provisional funds or against insufficient balances.

Receiver risk. Receiver risk arises when an institution accepts funds from a sender who may be a customer, another institution, or the payment system. As the receiver of funds, the institution relies on the sender's ability to settle its obligations. The risk exists while payments are revocable within the system and remains until final settlement.

Return-item risk. The major risk in originating ACH debit transactions and collecting checks for customers is return-item risk. Return-item risk extends from the day funds are made available to customers until the individual items can no longer legally be returned. The receiver of ACH debit transactions, or the payer of checks, has the right to return transactions for various reasons, including insufficient funds in its customer's account. To minimize its exposure, an institution should perform credit assessments of all customers that originate large dollar volumes of ACH debit transactions, and for all customers for which the institution collects large volumes of checks. Such assessments ensure that if ACH or check items are returned after the customer has been granted use of the funds, the customer will be able to return the funds to the institution.

Liquidity Risk

Liquidity risk is the risk that a counterparty will not settle an obligation for full value when due, even though the counterparty may later settle the obligation. Liquidity risk may result from unexpected market or operational disruptions or from catastrophic or unplanned events. It may also result from sovereign actions; therefore, sovereign risk can give rise to liquidity risk.

Sovereign Risk

Sovereign risk refers to the financial capacity of governments to generate foreign-currency revenues to repay their obligations. This capacity is generally limited because government assets are predominantly the discounted value of future taxes denominated in the local currency. Governments have direct access to foreign-currency revenues only when the economy is dominated by a public sector that derives most of its revenues from exports (for example, oil or gold). Sovereign risk is not limited to the country's federal government debt. It also includes debt contracted by all public and publicly guaranteed entities (such as provincial, state, or local governments and all other debt with a government's guarantee).

Actions taken by nondomestic governments can affect the payments of certain participants in a payment system, and these actions can be detrimental to other participants in the system. Sovereign risk can include the imposition of exchange-control regulations on a bank participating in international foreign-exchange activities. While the bank itself may be both willing and able to settle its position, government intervention may prevent it from doing so. The risk can be controlled by regularly monitoring the payment-system laws of other countries and by taking specific alternative actions to lessen the risk. Alertness to a bank's sovereign-risk exposure to its counterparties located in other nations, and to possible alternative actions, can considerably lessen this risk.

Legal Risk

Any transaction occurring in a payment system is subject to the interpretation of courts in different countries and legal systems. This issue is normally addressed by adopting "governing-law" provisions in the rules of the systems themselves. These provisions provide for all disputes between members to be settled under the laws of a specific jurisdiction. However, if a local court refuses to recognize the jurisdiction of a foreign court, the rules may be of limited use. This risk is difficult to address because there is no binding system of international commercial law for electronic payments. Banks should seek a legal opinion regarding the enforceability of transactions settled through a particular system.

Operational Risk

Operational risk may arise from—

- a system failure caused by a breakdown in the hardware or software supporting the system, possibly resulting from design defects, insufficient system capacity to handle transaction volumes, or a mechanical breakdown, including telecommunications;
- a system disruption if the system is unavailable to process transactions, possibly due to system failure, destruction of the facility (from natural disasters, fires, or terrorism), or operational shutdown (from employee actions, a business failure, or government action); or
- the system being compromised as a result of fraud, malicious damage to data, or error.

Whatever the source, the loss of availability of a payment system can adversely affect major participants, their correspondents, markets, and interdependent payment mechanisms.

Banks should control operational risk through a sound system of internal controls, including physical security, data security, systems testing, segregation of duties, backup systems, and contingency planning. In addition, a disruption to a bank's own internal payment processing systems or its access to external payment systems can adversely affect both the bank's own payments activities, as well as those of other participants in a payment system. As such, a comprehensive audit program is essential to assess the risks, adequacy of controls, and compliance with bank policies.

Risk-Control Issues

Bank management should consider and develop risk-management policies and procedures to address the variety of credit, liquidity, operational, and other risks that can arise in the normal course of conducting its payment business—regardless of the clearing and settlement method of the particular payment systems in which the bank participates. EFT systems differ widely in form, function, scale, and scope of activities. Consequently, the specific risk-management measures an institution employs for a particular EFT system will differ depending on the inherent risks in the system. As a general matter, an institution should adopt risk-management controls commensurate with the nature and magnitude of risks involved in a particular EFT system.

In addition to assessing the adequacy of an institution's risk-management procedures for measuring, monitoring, and controlling its risks from participating in a payment system (or systems) and from providing payment services to its customers, examiners should consider the following internal control guidelines when they review policies and procedures covering EFT activities:

- Job descriptions for personnel responsible for a bank's EFT activities should be well defined, providing for the logical flow of work and adequate segregation of duties.
- No single person in an EFT operation should be responsible for all phases of the transaction (that is, for data input, verification, and transmission or posting).
- All funds transfers should be reconciled at the end of each business day. The daily balancing process should include a reconciliation of both the number and dollar amount of messages transmitted.
- All adjustments required in the processing of a transfer request should be approved by a bank's supervisory personnel, with the reasons for the adjustment documented. Transfer requests "as of" a past or future date should require the supervisor's approval with well-defined reasons for those requests.
- Only authorized persons should have access to EFT equipment.

Considerable documentation is necessary to maintain adequate accounting records and auditing control. Many banks maintain transfer-request logs, assign sequence numbers to incoming and outgoing messages, and keep an unbroken electronic copy of all EFT messages. At the end of each business day, employees who are independent of the transfer function should compare request forms with the actual transfers to ensure that all EFT documents are accounted for. When reviewing the adequacy of internal controls, examiners should review the funds-transfer operations to determine that recordkeeping systems are accurate and reliable, all transactions are handled promptly and efficiently, duties are separated appropriately, audit coverage is adequate, and management recognizes the risks associated with these activities.

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Electronic Funds Transfer Risk Assessment

INTRODUCTION

As used in the context of state member bank supervision, the term "crypto-asset" generally refers to any digital asset implemented using cryptographic techniques, including tokens denominated in national currencies and issued using distributed ledger technology or similar technologies to facilitate payments (dollar tokens).[1] Crypto-asset-related activities may include, but are not limited to, crypto-asset safekeeping and traditional custody services; ancillary custody services; loans collateralized by crypto-assets; and issuance and distribution of dollar tokens.

The structure, risk, and scope of a state member bank's crypto-asset-related activities can vary considerably. While crypto-asset-related activities may present opportunities to banks, they could also pose risks related to safety and soundness, consumer protection, and financial stability. As such, state member banks engaging in permissible crypto-asset-related activities should have appropriate controls in place to engage in these activities in a safe-and-sound manner. The provision of traditional banking services (e.g., deposit accounts, ordinary lending) to crypto-asset-related entities is not considered to be a crypto-asset-related activity for a state member bank. State member banks should take appropriate measures to mitigate risks, including liquidity risks, associated with providing such services to crypto-asset-related entities. However, state member banks are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.

The purpose of this manual section is to

- clarify supervisory expectations regarding notification of engagement in crypto-asset-related activities;
- discuss legal permissibility concerns associated with a state member bank's engagement in crypto-asset-related activities;
- describe the supervisory nonobjection process for state member banks seeking to engage in certain activities involving dollar tokens;
- discuss statements on crypto-asset-related risks to banking organizations; and
- outline supervisory considerations in assessing state member banks engaged in crypto-asset-related activities.

NOTIFICATION REGARDING ENGAGEMENT IN CRYPTO-ASSET-RELATED ACTIVITIES

A state member bank should notify its lead supervisory point of contact at the responsible Reserve Bank prior to engaging in any crypto-asset-related activity. Any state member bank that is already engaged in crypto-asset-related activities should notify its Reserve Bank point of contact promptly regarding such activities, if it has not already done so.

Before engaging in any crypto-asset-related activities, a state member bank must ensure such activity is legally permissible and determine whether any filings are required under applicable federal or state laws. A state member bank should, prior to engaging in these activities, have in place adequate systems, risk management, and controls to conduct such activities in a safe-and-sound manner and consistent with all applicable laws, including applicable consumer protection statutes and regulations.

For more information, see SR 22-6/CA 22-6, "Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations."

LEGAL PERMISSIBILITY OF CRYPTO-ASSET-RELATED ACTIVITIES

Prior to engaging in new activities of any kind, a state member bank must ensure that such activities are legally permissible. A state member bank seeking to engage in (or currently engaged in) crypto-asset-related activities must

1. In Office of the Comptroller of the Currency (OCC) Interpretive Letter 1174, the OCC specifically recognized the authority of national banks to use distributed ledger technology or similar technologies to conduct payments activities as principal, including by issuing, holding, or transacting in dollar tokens. See OCC Interpretive Letter No. 1174 (January 4, 2021). The OCC uses the term "stablecoin" and the Board of Governors of the Federal Reserve (Board) uses the term "dollar token," but the terms are synonymous for purposes of OCC Interpretive Letter 1174. For the avoidance of doubt, any bank liabilities (including deposits) that meet the definition of dollar token above are "dollar tokens."

analyze the permissibility of such activities under relevant state and federal laws and determine whether any filings are required under state and federal laws and regulations, including the Federal Reserve Act, the Federal Deposit Insurance Act, and the Board's Regulation H (12 CFR pt. 208).

On January 27, 2023, the Board issued a Policy Statement on Section 9(13) of the Federal Reserve Act (Policy Statement). The Policy Statement sets out a rebuttable presumption that the Board will exercise its discretion under section 9(13) of the Federal Reserve Act to limit state member banks to engaging as principal in only those activities that are permissible for national banks—in each case, subject to the terms, conditions, and limitations placed on national banks with respect to the activity—unless those activities are permissible for state banks under federal law.[2]

A state member bank may rebut the presumption set out by the Policy Statement if

- there is a clear and compelling rationale for the Board to allow the proposed deviation in regulatory treatment among federally supervised banks; and
- the state member bank has robust plans for managing the risks of the proposed activity in accordance with principles of safe-and-sound banking.[3]

The preamble to the Policy Statement includes a discussion about how the Board would presumptively apply section 9(13) of the Federal Reserve Act to certain crypto-asset-related activities:[4]

- The Board would presumptively prohibit state member banks from holding most crypto-assets as principal.[5] Examiners should promptly notify Board Legal if they become aware of any state member bank holding crypto-assets as principal.[6]
- Further, state member banks seeking to issue, hold, or transact in dollar tokens would need to demonstrate, to the satisfaction of Federal Reserve supervisors, that the bank has controls in place to conduct the activity in a safe-and-sound manner and receive a supervisory nonobjection before commencing such activity.

The preamble also clarifies that nothing in the Policy Statement would prohibit a state member bank from providing safekeeping services for crypto-assets in a custodial capacity if such activities are conducted in a safe-and-sound manner and in compliance with consumer, anti-money-laundering, and anti-terrorist-financing laws.

The Policy Statement also reminds state member banks that legal permissibility is a necessary, but not sufficient, condition to establish that a state member bank may engage in a particular activity. It reiterates that a state member bank must, at all times, conduct its business and exercise its powers with due regard to safety and soundness. It states that a supervised banking organization is expected, at a minimum, to have internal controls and information systems that are appropriate for the nature, scope, and risks of its activities, including crypto-asset-related activities.[7]

2. 12 CFR 208.112(c). Board staff expects that, in these circumstances, insured state banks would likely be prohibited from engaging in the activity under section 24 of the Federal Deposit Insurance Act unless they receive authorization from the Federal Deposit Insurance Corporation (FDIC). See 12 CFR 208.112(e).

3. 12 CFR 208.112(d).

4. 88 Fed. Reg. 7848 (February 7, 2023).

5. For the purposes of the Policy Statement, the term "crypto-assets" refers to digital assets issued using distributed ledger technology and cryptographic techniques (for example, bitcoin and ether) but does not include such assets to the extent they are more appropriately categorized within a recognized, traditional asset class (for example, securities with an effective registration statement filed under the Securities Act of 1933 that are issued, stored, or transferred through the system of a regulated clearing agency and in compliance with all applicable federal and state securities laws). To the extent transmission using distributed ledger technology and cryptographic techniques changes the risks of a traditional asset (for example, through issuance, storage, or transmission on an open, public, and/or decentralized network, or similar system), the Board reserves the right to treat it as a "crypto-asset." See 88 Fed. Reg. 7848 (February 7, 2023).

6. Any question about whether a state member bank is conducting the activity "as principal" should be referred to Board Legal.

7. See 12 CFR 208.112(f); 12 CFR 208, Appendix D-1.

SUPERVISORY NONOBJECTION PROCESS FOR STATE MEMBER BANKS SEEKING TO ENGAGE IN CERTAIN ACTIVITIES INVOLVING DOLLAR TOKENS

SR-23-8/CA-23-5, "Supervisory Nonobjection Process for State Member Banks Seeking to Engage in Certain Activities Involving Dollar Tokens," clarifies that a state member bank seeking to engage in activities permitted for national banks under OCC Interpretive Letter 1174, including issuing, holding, or transacting in dollar tokens to facilitate payments, is required to demonstrate, to the satisfaction of Federal Reserve supervisors, that the bank has controls in place to conduct the activity in a safe-and-sound manner.[8] To verify this requirement has been met, a state member bank should receive a written notification of supervisory nonobjection from the Federal Reserve before engaging in the proposed activities.

A state member bank seeking to engage in such dollar token activities, including for the purpose of testing, must notify its lead supervisory point of contact at the Federal Reserve of the bank's intention to engage in the proposed activity and should include a description of the proposed activity. Federal Reserve supervisory staff may follow up with the bank to seek additional information in order to better understand the proposal and the control framework that the state member bank has put in place. After receiving a written notification of supervisory nonobjection, state member banks will continue to be subject to supervisory review and heightened monitoring of these activities.

To obtain a written notification of supervisory nonobjection, the state member bank should demonstrate that it has established appropriate risk-management practices for the proposed activities, including having adequate systems in place to identify, measure, monitor, and control the risks of its activities, and the ability to do so on an ongoing basis. Federal Reserve staff will focus on the risks discussed in the preamble to the Policy Statement with respect to dollar tokens, including

- *operational risks,* including those risks associated with the governance and oversight of the network; clarity of the roles, responsibilities, and liabilities of parties involved; and the transaction validation process (e.g., timing and finality of settlement of transactions, potential irreversibility of transactions, and the central authority of transaction records);
- *cybersecurity risks,* including risks associated with the network on which the dollar token is transacted, the use of smart contracts, and any use of open source code;
- *liquidity risks,* including the risk that the dollar token could experience substantial redemptions in a short period of time that would trigger rapid outflows of deposits;
- *illicit finance risks,* including risks relating to compliance with Bank Secrecy Act and Office of Foreign Asset Control requirements, which include requiring banking organizations to verify the identity of a customer, perform due diligence to understand the nature and purpose of the customer relationship, and perform ongoing monitoring to identify and report suspicious activity; and
- *consumer compliance risks,* including risks related to identifying and ensuring compliance with any consumer protection statutes and regulations that apply to the specific dollar token activity.

Federal Reserve staff will also assess whether the bank has demonstrated that it understands and will comply with laws that apply to the proposed activities.

For more information, see SR-23-8/CA-23-5.

STATEMENTS ON CRYPTO-ASSET-RELATED RISKS TO BANKING ORGANIZATIONS

Joint Statement on Crypto-Asset Risks to Banking Organizations

On January 3, 2023, the Board, FDIC, and OCC (federal banking agencies) issued a Joint Statement on Crypto-Asset Risks to Banking Organizations (Interagency Statement), which highlights key risks associated with crypto-assets and crypto-asset sector participants of which banking organizations should be aware and describes the federal banking agencies' ap-

8. Depending on the specifics of the proposed activity, filing requirements may apply. For example, some activities involving dollar tokens may represent a change in the general character of a bank's business. See 12 CFR 208.3.

proaches to supervision in this area. The Interagency Statement reiterates that supervised banking organizations should ensure that any crypto-asset-related activities that they intend to engage in can be performed in a safe-and-sound manner, and in compliance with applicable laws and regulations, including those designed to protect consumers (such as fair lending laws and prohibitions against unfair, deceptive, or abusive acts or practices).

The key risks associated with crypto-assets and crypto-asset sector participants cited in the Interagency Statement include

- risk of fraud and scams among crypto-asset sector participants;
- legal uncertainties related to custody practices, redemptions, and ownership rights, some of which are currently the subject of legal processes and proceedings;
- inaccurate or misleading representations and disclosures by crypto-asset companies, including misrepresentations regarding federal deposit insurance, and other practices that may be unfair, deceptive, or abusive, contributing to significant harm to retail and institutional investors, customers, and counterparties;
- significant volatility in crypto-asset markets, the effects of which include potential impacts on deposit flows associated with crypto-asset companies;
- susceptibility of stablecoins (dollar tokens) to run risk, creating potential deposit outflows for banking organizations that hold stablecoin (dollar token) reserves;
- contagion risk within the crypto-asset sector resulting from interconnections among certain crypto-asset participants, including through opaque lending, investing, funding, service, and operational arrangements. These interconnections may also present concentration risks for banking organizations with exposures to the crypto-asset sector;
- risk-management and governance practices in the crypto-asset sector exhibiting a lack of maturity and robustness; and
- heightened risks associated with open, public, and/or decentralized networks, or similar systems, including, but not limited to, the lack of governance mechanisms establishing oversight of the system; the absence of contracts or standards to clearly establish roles, responsibilities, and liabilities; and vulnerabilities related to cyber-attacks, outages, lost or trapped assets, and illicit finance.

The Interagency Statement also noted that

- the federal banking agencies have significant safety-and-soundness concerns with business models that are concentrated in crypto-asset-related activities or have concentrated exposures to the crypto-asset sector; and
- based on current understanding and experience to date, the federal banking agencies believe that issuing or holding as principal crypto-assets that are issued, stored, or transferred on an open, public, and/or decentralized network, or similar system, is highly likely to be inconsistent with safe-and-sound banking practices.

Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities

On February 23, 2023, the federal banking agencies issued a Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Interagency Liquidity Statement) on the liquidity risks presented by certain sources of funding from crypto-asset-related entities and some effective practices to manage such risks.

The Interagency Liquidity Statement does not create new risk-management principles but instead reminds banking organizations to apply existing risk-management principles, including as highlighted in the 2010 Interagency Policy Statement on Funding and Liquidity Risk Management,[9] to relationships with crypto-asset-related entities.

The Interagency Liquidity Statement notes that certain sources of funding from crypto-asset-related entities may pose heightened liquidity risks to banking organizations due to the unpredictability of the scale and timing of deposit inflows and outflows, including, for example

- *Deposits placed by a crypto-asset-related entity that are for the benefit of the crypto-asset-related entity's customers (end customers).* The stability of such deposits may be driven by the behavior of the end customer or crypto-asset sector dynamics, and not solely by the crypto-asset-related entity itself, which is the

9. SR-10-6, "Interagency Policy Statement on Funding and Liquidity Risk Management."

banking organization's direct counterparty. The stability of the deposits may be influenced by, for example, periods of stress, market volatility, and related vulnerabilities in the crypto-asset sector, which may or may not be specific to the crypto-asset-related entity. Such deposits can be susceptible to large and rapid inflows and outflows, when end customers react to crypto-asset-sector-related market events, media reports, and uncertainty. This uncertainty and resulting deposit volatility can be exacerbated by end customer confusion related to inaccurate or misleading representations of deposit insurance by a crypto-asset-related entity.
- *Deposits that constitute stablecoin-related (dollar token-related) reserves.* The stability of such deposits may be linked to demand for dollar tokens, the confidence of dollar token holders in the dollar token arrangement, and the dollar token issuer's reserve management practices. Such deposits can be susceptible to large and rapid outflows stemming from, for example, unanticipated dollar token redemptions or dislocations in crypto-asset markets.

The Interagency Liquidity Statement also notes that it is important for banking organizations to actively monitor the liquidity risks inherent in certain funding sources from crypto-asset-related entities, such as those described above, and to establish and maintain effective risk management and controls commensurate with the level of liquidity risks from such funding sources. The Interagency Liquidity Statement asserts that effective risk-management practices could include

- understanding the direct and indirect drivers of potential behavior of deposits from crypto-asset-related entities and the extent to which those deposits are susceptible to unpredictable volatility;
- assessing potential concentration or interconnectedness across deposits from crypto-asset-related entities and the associated liquidity risks;
- incorporating the liquidity risks or funding volatility associated with crypto-asset-related deposits into contingency funding planning, including liquidity stress testing and, as appropriate, other asset-liability governance and risk-management practices; and
- performing robust due diligence and ongoing monitoring of crypto-asset-related entities that establish deposit accounts, including assessing the representations made by those crypto-asset-related entities to their end customers about such deposit accounts that, if inaccurate, could lead to rapid outflows of such deposits.

The Interagency Liquidity Statement reiterates that banking organizations are neither prohibited nor discouraged from providing banking services to customers of any specific class or type, as permitted by law or regulation.

SUPERVISORY CONSIDERATIONS IN ASSESSING STATE MEMBER BANKS WITH CRYPTO-ASSET-RELATED ACTIVITIES

Examiners should assess a state member bank's crypto-asset-related activities following the general approach that is used for assessing other activities and risks at state member banks. Different crypto-asset-related activities and different business models should be evaluated according to their specific risks and may affect different CAMELS component ratings. For example, failure to mitigate the risks of a high concentration of deposits from crypto-asset-related entities would impact the Management and Liquidity ratings. Furthermore, examiners would address the financial weaknesses in the quality and performance of loans secured by crypto-assets in the bank's Asset Quality component rating.

Examiners should, to the extent possible in the scoping or supervisory planning process, understand the nature and volume of a state member bank's ongoing and planned crypto-asset-related activities prior to the examination or supervisory event. Examiners should identify the risks associated with a state member bank's ongoing and planned crypto-asset-related activities and assign Federal Reserve staff with appropriate expertise to assist in the supervisory assessment of the state member bank. Examiners should consider the following when reviewing a state member bank's ongoing and planned crypto-asset-related activities:

1. Identify each ongoing and planned crypto-asset-related activity, and consult internally with Board Legal or other staff, as appropriate, to determine whether such activity is

legally permissible and whether any filings or applications may be required.
   a. This may include an assessment, to be conducted by Board Legal, of whether a state member bank's crypto-asset-related activities have caused a change in the general character of the bank's business or in the scope of its corporate powers.[10]
   b. This also may include an assessment of whether a state member bank seeking to issue, hold, or transact in dollar tokens to facilitate payments must demonstrate, to the satisfaction of Federal Reserve supervisors, that the bank has controls in place to conduct the activity in a safe-and-sound manner and receive a supervisory nonobjection before commencing such activity.
2. Assess whether the state member bank's board understands its crypto-asset-related activities and risks and whether the activities align with the organization's overall risk tolerance or appetite.
3. Identify the state member bank's long-term strategic goals and assess how its crypto-asset-related activities support those goals and if there are any planned expansions of the existing crypto-asset-related activities to achieve those goals.
4. Assess whether senior management has the required expertise to manage the bank's crypto-asset-related activities.
5. Assess whether adequate training and educational resources are provided to all relevant staff, especially regarding any enhanced operational resilience, Bank Secrecy Act/Anti-Money-Laundering, and "know your customer" requirements.
6. Determine whether policies, procedures, and risk limits, including any concentrations, are appropriate.
7. Determine whether the state member bank has in place internal controls and information systems that are appropriate to the nature, scope, and risks of its activities.[11]
8. Ascertain whether the state member bank has appropriate systems to monitor and control risks, including
   a. financial risks (including liquidity, credit, and market);
   b. operational risks (including cybersecurity and use of third parties); and
   c. compliance risks (including compliance with Bank Secrecy Act and Office of Foreign Asset Control requirements to reduce the risk of illicit financial activity).
9. Determine whether reporting and communication systems are adequate and accurate.
10. Assess whether audit and independent review functions over crypto-asset-related activities are adequate.

10. 12 CFR 208.3(d)(2).

11. See 12 CFR pt. 208, appendix D-1.

6000—BANK REGULATIONS

The 6000 series of sections provide information on selected regulations that pertain to safety and soundness examinations of state member banks that are not already addressed in other parts of the manual. These sections summarize and explain the rules, as amended, but are not substitutes for the rules themselves. Refer to the *Code of Federal Regulations* (CFR) for more information on the Federal Reserve's regulations.

It is important for a federally insured depository institution[1] (bank) to control and limit the risk exposures posed to it by another domestic bank (whether or not that institution is an insured depository institution) or foreign bank with which it does business (referred to as a *correspondent*). These exposures may include all extensions of credit to a correspondent; deposits or reverse repurchase agreements with a correspondent; guarantees, acceptances, or standby letters of credit on behalf of a correspondent; purchases or acceptance as collateral of correspondent-issued securities; and all similar transactions. A bank needs to develop internal procedures to evaluate and control the risk exposures to the bank from its correspondents. Such procedures would help prevent a situation whereby the failure of a single correspondent could trigger the failure of a federally insured depository institution having claims on the failed correspondent. (See SR-93-36.)

A bank's principal sources of exposure to its correspondent tend to arise from two types of activity. First, banks may become exposed when obtaining services from (such as check-collection services), or providing services to, their correspondents. Second, exposure may arise when banks engage in transactions with correspondents in the financial markets. Each type of exposure has its own characteristics and its own risks.

Correspondent banking services are the primary source of interbank exposure for the majority of banks, particularly small and medium-sized banks. In connection with check-collection services and other trade- or payment-related correspondent services, banks often maintain balances with their correspondents in order to settle transactions and compensate the correspondents for the services provided. These balances give rise to exposure to the correspondents. Although correspondent services are in some cases provided on a fee basis, many correspondents may prefer compensating-balance arrangements, as these balances provide the correspondents with a stable source of funding. Also, some banks may prefer to pay for services with "soft charges" in the form of balances instead of "hard charges" in the form of fees.

Exposure to a correspondent may be significant, particularly when a bank uses one correspondent for all of its check collections and other payment services; loans excess reserve account balances (federal, or fed, funds) to the correspondent,[2] or engages in other banking transactions with correspondents.[3] This exposure may increase when interest rates fall, as higher levels of compensating balances may be required to provide adequate compensation to the correspondent.

Money-center banks and large regional banks may have significant exposure to correspondents[4] through their activities in interbank markets, such as the securities, swap, and foreign-exchange markets. Interbank transactions that call for performance in the future (such as swaps, foreign-exchange contracts, and over-the-counter options) give rise to exposure to the correspondents that act as counterparties[5] in such transactions. In addition to credit risk, such transactions may involve interest-rate risk,

1. A federally insured depository institution refers to a bank, as defined in section 3 of the Federal Deposit Insurance Act (12 USC 1813), and includes a federally insured national bank, state bank, District bank, or savings association, and a federally insured branch of a foreign bank.

2. In the fed funds market, a loan of fed funds is often referred to as a sale. Borrowing of fed funds is referred to as a purchase.

3. Although a bank's primary correspondent often will borrow (purchase) fed funds as principal directly from the bank, a correspondent may act as agent to place the funds with another institution. In such agency arrangements, a bank may provide its correspondent with a preapproved list of institutions with which the correspondent may place the funds. When a correspondent is acting as the bank's agent in placing fed funds, the bank's exposure would be to the ultimate purchaser of the funds, not to the correspondent placing the funds on its behalf.

Generally, fed funds loans are unsecured. A bank may also provide funds to a correspondent through transactions known as *reverse repurchase agreements*, in which the bank provides funds to the correspondent by buying an asset, generally a government security. The correspondent agrees that it will repurchase the asset from the bank at the expiration of a set period, generally overnight, at a repurchase price calculated to compensate the bank for the use of its funds. Unlike fed funds loans, these transactions are essentially secured transactions.

4. Although the depository institutions that are parties to transactions in the interbank markets discussed above generally are referred to as *counterparties*, the term *correspondent* is used in this discussion to denote any domestic depository institution or a foreign bank to which a bank is exposed. The term *correspondent* does not include a commonly controlled correspondent, as defined in section 206.2(b) of Regulation F.

5. In other banking transactions, such as foreign-exchange, money market, and other permissible transactions, activities, or contractual arrangements, the other party to the transaction is referred to as the counterparty rather than as the correspondent.

foreign-exchange risk, and settlement risk. Settlement risk is the risk that a counterparty will fail to make a payment or delivery in a timely manner. Settlement risk may arise from unsecured transactions in the government securities, foreign-exchange, or other markets, and it may result from operational, liquidity, or credit problems.

Lending limits prohibit national banks from lending amounts equal to more than 15 percent of a national bank's unimpaired capital and surplus to a single borrower on an unsecured basis (12 USC 84(a)(1)); these limits also prohibit a national bank from lending an additional 10 percent on a secured basis (12 USC 84(a)(2)). The national bank lending limits apply only to "loans and extensions of credit," and the limits do not include most off-balance-sheet transactions that may provide significant sources of exposure to correspondents. Additionally, the national bank lending limits do not apply to overnight fed funds loans, a significant source of short-term exposure to correspondents. State limits generally do not apply to a broader range of transactions than the national bank limits, although some states include fed funds transactions within their limits.

State-chartered banks generally are subject to lending limits under state law. Almost all states impose lending limits on the banks they charter. Most of these limits are patterned on the national bank lending limits, although the specific percentages or transactions covered vary. The state limits generally do not apply to a broader range of off-balance-sheet transactions, although some states include fed funds transactions within their limits. A number of states, however, exclude interbank transactions from their lending limits entirely.

LIMITS ON INTERBANK LIABILITIES

Regulation F, Limitations on Interbank Liabilities (12 CFR 206), implemented section 308 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which amended section 23 of the Federal Reserve Act (12 USC 371b-2). Section 23, as amended, requires the Board of Governors of the Federal Reserve System (the Board) to prescribe standards to limit the risks posed by exposure of banks to other domestic depository institutions and foreign banks. Regulation F sets forth these standards. All depository institutions insured by the FDIC are subject to the Federal Reserve Board's Regulation F.[6] Regulation F was first adopted in 1992 and has remained substantially the same, except for the technical amendments adopted by the Board on September 10, 2003. (See 68 *Fed. Reg.* 53,283.) Regulation F consists of two primary parts: (1) prudential standards that apply to exposures generally (section 206.3) and (2) special rules that apply to credit exposure under certain circumstances (section 206.4).

The "Prudential Standards" section requires depository institutions to develop and adopt internal policies and procedures to evaluate and control all types of exposures to correspondents with which they do business.[7] Policies and procedures are to be established and maintained to prevent excessive exposure to any individual correspondent in relation to the condition of the correspondent. The "Prudential Standards" section requires a bank to adopt internal exposure limits when the financial condition of the correspondent and the form or maturity of the exposure create a significant risk that payments will not be made in full or on time. This section also provides that a bank shall structure the transactions of a correspondent or monitor exposures to a correspondent such that the bank's exposure ordinarily does not exceed its internal limits.

The "Credit Exposure" section provides that a bank's internal limit on interday *credit exposure* to an individual correspondent may not be more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized," as defined in section 206.5(a) of the rule. No limit is specified for credit exposure to correspondents that are at least adequately capitalized, but prudential standards are required for all correspondents, regardless of capital level. The term *correspondent* includes both domestically chartered depository institutions that are FDIC insured and foreign banks; the term does not include a commonly controlled correspondent.

6. Correspondent is defined in section 206.2(c) of Regulation F to mean a U.S. depository institution or a foreign bank to which a bank has exposure, but does not include commonly controlled correspondents.

7. Banks had to have the internal policies and procedures in place on June 19, 1993.

Prudential Standards

Standards for Selecting Correspondents

Banks are to address the risk arising from exposure to a correspondent, taking into account the financial condition of the correspondent and the size, form, and maturity of its exposure to the correspondent. Banks must adopt internal policies and procedures that evaluate the credit and liquidity risks, including operational risks, in selecting correspondents and terminating those relationships. Depository institutions are permitted to adopt flexible policies and procedures in order to permit resources to be allocated in a manner that will result in real reductions in risk. The policies and procedures must be reviewed annually by the bank's board of directors, but individual correspondent relationships need not be approved by the board. Examiners should determine that the policies and procedures adopted by the board provide for a determination of the credit, liquidity, and operational risks of a correspondent when the relationship with the correspondent is established and as it is maintained.[8] Additionally, if the bank has significant operational risk—such as relying on a correspondent for extensive data processing—that exposure could also lead to liquidity problems. This exposure may not be an issue for institutions that are not operationally dependent on any particular correspondent. Many banks may also address this exposure elsewhere in their operational procedures.

A bank's policies and procedures should provide for periodic review of the financial condition of any correspondent to which the bank has significant exposure. This review should evaluate whether the size and maturity of the exposure is commensurate with the correspondent's financial condition.[9] Factors bearing on the financial condition of the correspondent include, but are not necessarily limited to, (1) the capital level of the correspondent, (2) the level of nonaccrual and past-due loans and leases, and (3) the level of earnings.

Examiners should determine that a bank has periodically reviewed the financial condition of any correspondent to which the bank has significant exposure. The frequency of these reviews will depend on the size and maturity of the exposure and the condition of the correspondent. For example, the policies of many banks provide for an extensive annual review of a correspondent's financial condition; such policies may also provide for less extensive interim reviews under some circumstances, such as when exposure to a correspondent is very high or when a correspondent has experienced financial difficulty. A bank need not require periodic review of the financial condition of all correspondents. For example, periodic reviews would not be necessary for a correspondent to which the bank has only insignificant levels of exposure, such as small balances maintained for clearing purposes.[10] Significant levels of exposure should reflect those amounts that a prudent bank believes deserve analysis for risk of loss.

A bank may base its review of the financial condition of a correspondent on publicly available information, such as bank Call Reports, financial statements or reports, Uniform Bank Performance Reports, or annual reports, or the bank may use financial information obtained from a rating service. A bank generally is not required to obtain nonpublic information to use as the basis for its analysis and review of the financial condition of a correspondent.[11] For

8. *Liquidity risk* and *operational risk* are terms used in the definition of exposure. Liquidity risk is the risk that payment will be delayed for some period of time. For example, a bank is subject to the liquidity risk that a payment due from a failed correspondent will not be made on time; the bank's credit risk may be a lesser amount due to later distributions from the correspondent's receiver. Liquidity risk is included in the definition of exposure.

Operational risk is the risk that a correspondent's operational problems may prevent it from making payments, thereby creating liquidity risks for other banks. For example, a computer failure at a correspondent that a bank relies on for extensive data processing support may prevent the correspondent from making payments, and thus may create liquidity problems for the bank and other banks as well. Operational risk is also included in the definition of exposure.

9. Because exposure to a Federal Reserve Bank or Federal Home Loan Bank poses minimal risk to a respondent, Federal Reserve Banks and Federal Home Loan Banks are not included in the definition of correspondent.

10. Other forms of exposure that generally would not be considered significant include (1) a collecting bank's risk that a check will be returned, (2) an originating bank's risk that an automated clearinghouse (ACH) debit transfer will be returned or its settlement reversed, (3) a receiving bank's remote risk that settlement for an automated credit transfer could be reversed, or (4) a credit card transaction. In these types of transactions, the amounts involved are generally small, and the exposed bank usually has prompt recourse to other parties.

11. A bank *is* required to obtain nonpublic information to evaluate a correspondent's condition for those foreign banks for which no public financial statements are available. In these limited circumstances, the bank would need to obtain financial information for its review (including information obtained directly from the correspondent).

correspondents with which a bank has a significant relationship, a bank may have considerable nonpublic information, such as information on the quality of management, general portfolio composition, and similar information, but such information is not always available and is not required.

Regardless of whether public or nonpublic sources of information are used, a bank may rely on another party, such as a bank rating agency, its bank holding company, or another correspondent, to assess the financial condition of or select a correspondent, provided that the board of directors has reviewed and approved the general assessment or selection criteria used by that party. Examiners should ascertain that the bank reviews and approves the assessment criteria used by such other parties. Additionally, when a bank relies on its bank holding company to select and monitor correspondents—or relies on a correspondent, such as a bankers' bank, to choose other correspondents with which to place the bank's federal funds or other deposits—examiners should ensure that the bank has reviewed and approved the selection criteria used.

Internal Limits on Exposure

When the financial condition of the correspondent and the form or maturity of the exposure represent a significant risk that payments will not be made in full or in a timely manner, a bank's policies and procedures must limit its exposure to the correspondent, either by the establishment of internal limits or by other means. Limits are to be consistent with the risks undertaken, considering the financial condition and the form and maturity of the exposure to the correspondent. Limits may specify fixed exposure amounts, or they may be more flexible and be based on factors such as the monitoring of exposure and the financial condition of the correspondent. Different limits may be set for different forms of exposure, different products, and different maturities.

When a bank has exposure to a correspondent that has a deteriorating financial condition, examiners should determine if the bank took that deterioration into account when it evaluated the correspondent's creditworthiness. The examiner should also evaluate if the bank's level of exposure to the correspondent was appropriate.

Examiners need to determine that the bank's policy and procedural limits are consistent with the risk undertaken, given the maturity of the exposure and the condition of the correspondent. Inflexible dollar limits may not be necessary in all cases. As stated earlier, limits can be flexible and be based on factors such as the level of the bank's monitoring of its exposure and the condition of the correspondent. For example, a bank may choose not to establish a specific limit on exposure to a correspondent when the bank is able to ascertain account balances with the correspondent on a daily basis, because such balances could be reduced rapidly if necessary. In appropriate circumstances, a bank may establish limits for longer-term exposure to a correspondent, while not setting limits for interday (overnight) or intraday (within the day) exposure. Generally, banks do not need to set one overall limit on their exposure to a correspondent. Banks may prefer instead to set separate limits for different forms of exposure, products, or maturities. A bank's evaluation of its overall facility with a correspondent should take into account utilization levels and procedures for further limiting or monitoring overall exposure.

When a bank has established internal limits for its significant exposure, examiners should ensure that the bank either (1) has procedures to monitor its exposure to remain within established limits or (2) structures transactions with the correspondent to ensure that the exposure ordinarily remains within the bank's established internal limits. While some banks may monitor actual overall exposure, others may establish individual lines for significant sources of exposure, such as federal funds sales. For such banks, the examiner should ensure that the bank has established procedures to ensure that exposure generally remains within the established lines. In some instances, a bank may accomplish this objective by establishing limits on exposure that are monitored by a correspondent, such as for sales of federal funds through the correspondent as agent.

When a bank monitors its exposures, the appropriate level of monitoring will depend on (1) the type and volatility of the exposure, (2) the extent to which the exposure approaches the bank's internal limits for the correspondent, and (3) the condition of the correspondent. Generally, monitoring may be conducted retrospectively. Examples of retrospective monitoring include checking close-of-business balances at a correspondent for the prior day or obtaining daily balance records from a correspondent at the end of each month. Thus, banks are not expected to monitor exposure to correspondents on a real-time basis.

The purpose of requiring banks to monitor or structure their transactions that are subject to limits is to ensure that the bank's exposure generally remains within established limits. However, occasional excesses over limits may result from factors such as unusual market disturbances, unusual favorable market moves, or other unusual increases in activity or operational problems. Unusual late incoming wires or unusually large foreign cash letters (international pouch) would be considered examples of activities that could lead to excesses over internal limits and that would not be considered impermissible under the rule. Examiners should verify that banks have established appropriate procedures to address any excesses over internal limits.

A bank's internal policies and procedures must address intraday exposure. However, as with other exposure of longer maturities (i.e., interday or longer), the rule does not necessarily require that limits be established on intraday exposure. Examiners should expect to see such limits or frequent monitoring of balances only if the size of the intraday exposure and the condition of the correspondent indicate a significant risk that payments will not be made as contemplated. Examiners should keep in mind that intraday exposure may be difficult for a bank to actively monitor and limit. Consequently, like interday exposure, intraday exposure may be monitored retrospectively. In addition, smaller banks may limit their focus on intraday exposure to being aware of the range of peak intraday exposure to particular institutions and the effect that exposure may have on the bank. For example, a bank may receive reports on intraday balances from a correspondent on a monthly basis and would only need to take actions to limit or more actively monitor such exposure if the bank becomes concerned about the size of the intraday exposure relative to the condition of the correspondent.

Credit Exposure

A bank's internal policies and procedures must limit overnight credit exposure to an individual correspondent to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized.[12] The credit exposure of a bank to a correspondent shall consist of the bank's assets and off-balance-sheet items that are (1) subject to capital requirements under the capital adequacy guidelines of the bank's primary federal supervisor and (2) involve claims on the correspondent or capital instruments issued by the correspondent.[13] Credit exposure therefore includes items such as deposit balances with a correspondent, fed funds sales, and credit-equivalent amounts of interest-rate and foreign-exchange-rate contracts and other off-balance-sheet transactions. Credit exposure does not include settlement of transactions, transactions conducted in an agency or similar capacity where losses will be passed back to the principal or other party, and other sources of exposure that are not covered by the capital adequacy guidelines or that do not involve exposure to a correspondent.[14] A bank may exclude the following from the calculation of credit exposure to a correspondent: (1) transactions, including reverse repurchase agreements, to the extent that the transactions are secured by government securities or readily marketable collateral; (2) the proceeds of checks and other cash items depos-

12. Total capital is the total of a bank's tier 1 and tier 2 capital calculated according to the risk-based capital guidelines of the bank's primary federal supervisor. For an insured branch of a foreign bank organized under the laws of a country that subscribes to the principles of the Basel Capital Accord, *total capital* means total tier 1 and tier 2 capital as calculated under the standards of that country. For an insured branch of a foreign bank organized under the laws of a country that does not subscribe to the principles of the Basel Capital Accord, *total capital* means total tier 1 and tier 2 capital as calculated under the provisions of the accord. The limit on credit exposure of the insured branch of a foreign bank is based on the foreign bank's total capital, as defined in this section, not on the imputed capital of the branch.

For purposes of Regulation F, an adequately capitalized correspondent is a correspondent with a total risk-based capital ratio of 8.0 percent or greater, a tier 1 risk-based capital ratio of 4.0 percent or greater, and a leverage ratio of 4.0 percent or greater. The leverage ratio does not apply to correspondents that are foreign banks. See section 206.5(e) for definitions of these terms.

13. A bank is required to include with its own credit exposure 100 percent of the credit exposure of any subsidiary that the bank is required to consolidate on its bank Call Report. This provision generally captures the credit exposure of any majority-owned subsidiary of the bank. Therefore, none of a minority-owned subsidiary's exposure and all of a majority-owned subsidiary's exposure would be included in the parent bank's exposure calculation.

14. For example, when assets of a bank, such as securities, are held in safekeeping by a correspondent, there is no exposure to the correspondent, even though the securities themselves may be subject to a capital charge.

ited in an account at a correspondent that are not yet available for withdrawal, (3) quality assets on which the correspondent is secondarily liable, or obligations of the correspondent on which a creditworthy obligor in addition to the correspondent is available; (4) exposure that results from the merger with or acquisition of another bank for one year after that merger or acquisition is consummated; and (5) the portion of the bank's exposure to the correspondent that is covered by federal deposit insurance. (See section 206.4(d) for a more detailed discussion of these exclusions.) This regulatory limit on credit exposure should be implemented as part of the bank's policies and procedures required under the "Prudential Standards" section. Regulation F does not impose regulatory limits for "credit exposure" to adequately or well-capitalized correspondents.

Quarterly monitoring of capital is only required for correspondents to which a bank's potential credit exposure is more than 25 percent of its total capital.[15] If the internal systems of a bank ordinarily limit credit exposure to a correspondent to 25 percent or less of the exposed bank's total capital, no monitoring of the correspondent's capital would be necessary, although periodic reviews of the correspondent's financial condition may be required under the "Prudential Standards" section if exposure to the correspondent is significant. Every effort should be made to allow banks to use existing risk-monitoring and -control systems and practices when these systems and practices effectively maintain credit exposure within the prescribed limits. For smaller institutions, it is relatively easy to determine how their measure of exposure compares with the definition of credit exposure in Regulation F because these institutions have relatively simple types of exposure. Examiners should remember that the regulation emphasizes appropriate levels of exposure based on the exposed bank's analysis of the creditworthiness of its correspondents. Accordingly, for those correspondents that the bank has not demonstrated are at least adequately capitalized, this limit should be viewed as a maximum credit-exposure level rather than as a safe-harbor level of credit exposure.

Examiners should ensure that the bank has in place policies and procedures that ensure the quarterly monitoring of the capital of its domestic correspondents. This quarterly schedule allows the bank to pick up information from the correspondent's most recent bank Call Report, financial statement, or bank rating report. Currently, it is difficult to obtain information on the risk-based capital levels of a correspondent. Regulation F requires that a bank must be able to demonstrate only that its correspondent's capital ratios qualify it as at least adequately capitalized.

A bank is not limited to a single source of information for capital ratios. A bank may rely on capital information obtained from a correspondent, a bank rating agency, or another reliable source of information. Further, examiners should anticipate that most banks will receive information on their correspondent's capital ratios either directly from the correspondents or from a bank rating agency. The standard used in the rule is based solely on capital ratios and does not require disclosure of CAMELS ratings. For foreign bank correspondents, monitoring frequency should be related to the frequency with which financial statements or other regular reports are available. Although such information is available quarterly for some foreign banks, financial statements for many foreign banks are generally available only on a semiannual basis.

Information on risk-based capital ratios may not be available for many foreign bank correspondents. As with domestic correspondents, however, examiners should anticipate that in most instances the correspondent will provide the information to the banks with which it does business.

A bank's internal policies and procedures should limit overnight credit exposure to a correspondent to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least adequately capitalized, as defined by the rule. However, examiners should not necessarily expect banks to have formal limits on credit exposure to a correspondent for which the bank does not maintain quarterly capital information or that is a less than adequately capitalized correspondent if the banks' policies and procedures effectively limit credit exposure to an amount below the 25 percent limit of total capital. Such situations include those in which

15. Because information on risk-based capital ratios for banks is generally based on the bank Call Report, a bank would be justified in relying on the most recently available reports based on Call Report data. While there may be a significant lag in such data, Call Reports are useful for monitoring trends in the condition of a correspondent—especially when a bank follows the data on a continuing basis.

only small balances are maintained with the correspondent or in which the correspondent has only been approved for a limited relationship. Although in many cases it will be necessary for a bank to establish formal internal limits to meet the regulatory limit, the provisions of section 206.3 (prudential standards) concerning excesses over internal limits also apply to limits established for the purpose of controlling credit exposure under section 206.4 of Regulation F.

The following examination objectives should be considered when examiners are (1) evaluating the bank's interbank liabilities with respect to its credit exposures to correspondents and (2) assessing the bank's compliance with Regulation F.

1. To determine if the policies, practices, procedures, and internal controls for interbank liabilities adequately address the risks posed by the bank's exposure to other domestic depository institutions and foreign banks.
2. To determine if bank officers and employees are operating in compliance with the policies and procedures established by the bank.
3. To determine if the financial condition of correspondents to which the bank has significant exposure—significant both in the size and maturity of the exposure and the financial condition of the correspondent—is reviewed periodically.
4. To determine if internal limits on exposure (1) have been established where necessary and (2) are consistent with the risk undertaken.
5. To determine if (1) exposure ordinarily remains within the established internal limits and (2) appropriate procedures have been established to address excesses over internal limits.
6. To determine that a bank's credit exposure to less than adequately capitalized correspondents is not more than 25 percent of the exposed bank's total capital. (Note that Regulation F places greater emphasis on maintaining appropriate levels of exposure based on a bank's analysis of the creditworthiness of its correspondents as opposed to merely staying within regulatory established limits.)
7. To determine if those correspondents to which the bank has credit exposure exceeding 25 percent of total capital are monitored quarterly to ensure that such correspondents remain at least adequately capitalized.
8. To reach agreement with the board of directors and senior management to initiate corrective action when policies, procedures, or internal controls are deficient, or when there are violations of laws or regulations.

Examiners should obtain or prepare the information necessary to perform the appropriate procedural steps.

1. If selected for implementation, complete or update the "Interbank Liabilities" section of the internal control questionnaire.
2. On the basis of an evaluation of the bank's internal controls, 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.
4. Request bank files relating to its exposure to its correspondents, as exposure is defined in Regulation F and applied and used in the "Prudential Standards" section of the regulation.

   a. Request documentation demonstrating that the bank has periodically reviewed the financial condition of any correspondent to which the depository institution has significant exposure. Factors bearing on the financial condition of the correspondent that should be addressed by the bank (depository institution) include the capital level of the correspondent, the level of nonaccrual and past-due loans and leases, the level of earnings, and other factors affecting the financial condition of the correspondent.
   b. Request that the bank provide information indicating its level of exposure to each correspondent, as measured by the bank's internal control systems (for smaller banks, this information may include correspondent statements and a list of securities held in the investment portfolio).
   c. Determine if the frequency of the bank's reviews of its correspondents' financial condition is adequate for those correspondents to which the bank has very large or long maturities or for correspondents in deteriorating condition.
   d. If a bank relies on another party (such as a bank rating agency, its bank holding company, or another correspondent) to provide financial analysis of a correspondent, determine if the bank's board of directors has reviewed and approved the assessment criteria used by the other party.
   e. When the bank relies on its bank holding company or on a correspondent, such as a bankers' bank, to select and monitor correspondents or to choose other correspondents with which to place the depository institution's federal funds, ensure that the bank's board of directors has reviewed and approved the selection criteria used.
   f. If the bank is exposed to a correspondent that has experienced deterioration in its financial condition, ascertain whether the bank has taken the deterioration into account in its evaluation of the creditworthiness of the correspondent and of the appropriate level of exposure to the correspondent.
   g. When the bank has established internal limits for significant exposure, determine that the bank either monitors its exposure or structures transactions with the correspondent to ensure that exposure ordinarily remains within the bank's internal limits for the risk undertaken.
   h. If the bank chooses to set separate limits for different forms of exposure, products, or maturities and does not set an overall internal limit on exposure to a correspondent, review information on actual interday exposure to determine if the aggregate exposure (especially for less than adequately capitalized correspondents or financially deteriorating correspondents) is consistent with the risk undertaken.
   i. When a bank monitors its exposures, determine if the level of monitoring of significant exposure (especially for less than adequately capitalized correspondents or financially deteriorating correspondents) is adequate, commensurate with the type and volatility of exposure, the extent to which the exposure approaches the bank's internal limits, and the condition of the correspondent.
   j. Determine if the bank had any occasional excesses in exposure over its internal

limits. If so, verify that the bank used appropriate and adequate procedures to address such excesses.

k. If the size of intraday exposure to a correspondent and the condition of the correspondent indicate a significant risk that payments will not be made in full or in a timely manner, verify that the bank has established intraday limits consistent with the risk undertaken and that it has monitored its intraday exposure.

5. Request and review a list of the correspondent transaction files for all domestic depository institutions and foreign banks to which the bank regularly has credit exposure (as defined in section 206.4 of Regulation F) exceeding 25 percent of the bank's total capital during a specified time interval. (Where appropriate, every effort should be made to allow banks to use existing risk-monitoring and -control systems and practices when these systems and practices effectively maintain credit exposure within the prescribed limits). Review the bank's files to—
   a. verify that the correspondent's capital levels are monitored quarterly;
   b. verify that these correspondents are at least adequately capitalized, in compliance with Regulation F; and
   c. determine that the credit exposure to those correspondents that are at risk of dropping below the adequately capitalized capital levels could be reduced to 25 percent or less of the bank's total capital in a timely manner.

Review the bank's internal controls, policies, practices, and procedures for interbank liabilities and compliance with the Board's Regulation F. The bank's system should be documented completely and concisely and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information. When identifying and resolving any existing deficiencies, examiners should seek the answers to the following key questions.

PRUDENTIAL STANDARDS

1. Has the bank developed written policies and procedures to evaluate and control its exposure to all of its correspondents?
2. Have the written policies and procedures been reviewed and approved by the board of directors annually?
3. Do the written policies and procedures adequately address the bank's exposure(s) to a correspondent, including credit risk, liquidity risk, operational risk, and settlement risk?
4. Has the bank adequately evaluated its intraday exposure? Does the bank have significant exposure to its correspondent from operational risks, such as extensive reliance on a correspondent for data processing? If so, has the bank addressed these operational risks?
5. Do the bank's written policies and procedures establish criteria for selecting a correspondent or terminating that relationship?
6. Do the bank's written policies and procedures require a periodic review of the financial condition of a correspondent whenever the size and maturity of exposure is considered significant in relation to the financial condition of the correspondent?
7. When exposure is considered significant, is the financial condition of a correspondent periodically reviewed?
8. Does the periodic review of a correspondent's financial condition include—
   a. the level of capital?
   b. the level of nonaccrual and past-due loans and leases?
   c. the level of earnings?
   d. other factors affecting the financial condition of the correspondent?
9. If a party other than bank management conducts the financial analysis of or selects a correspondent, has the bank's board of directors reviewed and approved the general assessment and selection criteria used by that party?
10. If the financial condition of a correspondent, or the form or maturity of the bank's exposure to that correspondent, creates significant risk, do the bank's written policies and procedures establish internal limits or other procedures, such as monitoring, to control exposure?
11. Are the bank's internal limits or controls appropriate for the level of its risk exposure to correspondents? If no internal limits have been established, is this appropriate based on the financial condition of a correspondent and the size, form, and maturity of the bank's exposure? What are your reasons for this conclusion?
12. When internal limits for significant exposure to a correspondent have been set, has the bank established procedures and structured its transactions with the correspondent to ensure that the exposure ordinarily remains within the bank's established internal limits?
13. If not, is actual exposure to a correspondent monitored to ensure that the exposure ordinarily remains within the bank's established internal limits?
14. Is the level (frequency) of monitoring performed appropriate for—
    a. the type and volatility of the exposure?
    b. the extent to which the exposure approaches the bank's internal limits?
    c. the financial condition of the correspondent?
15. Are transactions and monitoring reports on exposure reviewed for compliance with internal policies and procedures? If so, by whom and how often?
16. Do the bank's written policies and procedures address deterioration in a correspondent's financial condition with respect to—
    a. the periodic review of the correspondent's financial condition?
    b. appropriate limits on exposure?
    c. the monitoring of the exposure, or the

structuring of transactions with the correspondent, to ensure that the exposure remains within the established internal limits?

Are these measures appropriate and realistic?

17. Do the bank's written procedures establish guidelines to address excesses over its internal limits? (Such excesses could include unusual late incoming wires, unusually large foreign cash letters (international pouch), unusual market moves, or other unusual increases in activity or operational problems.) Are the procedures appropriate?

CREDIT-EXPOSURE LIMITS

1. Do the bank's written policies and procedures effectively limit overnight credit exposure to 25 percent or less of the bank's total capital, if a correspondent is less than adequately capitalized?
2. If credit exposure is not limited to 25 percent or less of the bank's total capital, does the bank—
   a. obtain quarterly information to determine its correspondent's capital levels (if so, determine the source of the information)?
   b. monitor its overnight credit exposure to its correspondents (if so, determine the frequency)?

This interagency guidance reminds institutions of supervisory expectations on sound practices for managing risks associated with funding and credit concentrations arising from correspondent relationships (correspondent concentration risk).[1] The guidance highlights the need for institutions to identify, monitor, and manage correspondent concentration risk on a standalone and organization-wide basis and to take into account exposures to the correspondents' affiliates as part of their prudent risk-management practices. Institutions also should be aware of their affiliates' exposures to correspondents as well as the correspondents' subsidiaries and affiliates. The guidance also reinforces the supervisory view that financial institutions should perform appropriate due diligence on all credit exposures to, and funding transactions with, other financial institutions. See SR-10-10 and its attachments. Also see 75 *Fed. Reg.* 23764, May 4, 2010.

INTERAGENCY GUIDANCE ON CORRESPONDENT CONCENTRATION RISKS

A financial institution's[2] relationship with a correspondent[3] may result in credit (asset) and funding (liability) concentrations. On the asset side, a credit concentration represents a significant volume of credit exposure that a financial institution has advanced or committed to a correspondent. On the liability side, a funding concentration exists when an institution depends on one or a few correspondents for a disproportionate share of its total funding.

The Federal Reserve[4] realizes some concentrations meet certain business needs or purposes, such as a concentration arising from the need to maintain large ''due from'' balances to facilitate account clearing activities. However, correspondent concentrations represent a lack of diversification, which adds a dimension of risk that management should consider when formulating strategic plans and internal risk limits.

The Federal Reserve considers credit exposures greater than 25 percent of total capital[5] as concentrations. While a liability concentration threshold has not been established, the Federal Reserve has seen instances where funding exposures as low as 5 percent of an institution's total liabilities have posed an elevated liquidity risk to the recipient institution.

These levels of credit and funding exposures are not firm limits but indicate an institution has concentration risk with a correspondent. Such relationships warrant robust risk-management practices, particularly when aggregated with other similarly sized funding concentrations, in addition to meeting the minimum regulatory requirements specified in applicable regulations. Financial institutions should identify, monitor, and manage both asset and liability correspondent concentrations and implement procedures to perform appropriate due diligence on all credit exposures to and funding transactions with correspondents, as part of their overall risk-management policies and procedures.

This guidance does not supplant or amend applicable regulations, such as the Board's *Limitations on Interbank Liabilities* (Regulation F).[6] This guidance clarifies that financial institutions should consider taking actions beyond the minimum requirements established in Regulation F to identify, monitor, and manage correspondent concentration risks in order to maintain risk-management practices consistent with safe and sound operations, especially when there are rapid changes in market conditions or in a correspondent's financial condition.

1. See, for example, section 2015.1 or SR-93-36.
2. This guidance applies to all banks and their subsidiaries, bank holding companies and their nonbank subsidiaries, savings associations and their subsidiaries, and savings and loan holding companies and their subsidiaries that are supervised by the Board of Governors of the Federal Reserve System.
3. Unless the context indicates otherwise, references to ''correspondent'' include the correspondent's holding company, subsidiaries, and affiliates. A correspondent relationship results when a financial organization provides another financial organization a variety of deposit, lending, or other services.
4. The interagency guidance references, collectively, the Agencies, meaning the Board of Governors of the Federal Reserve System (Board), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).
5. For purposes of this guidance, the term ''total capital'' means the total risk-based capital as reported for commercial banks and thrifts in the Report of Condition and the Thrift Financial Report, respectively.
6. 12 CFR 206. All depository institutions insured by the FDIC are subject to the Board's Regulation F.

Identifying Correspondent Concentrations

Institutions should implement procedures for identifying correspondent concentrations. For prudent risk-management purposes, these procedures should encompass the totality of the institutions' aggregate credit and funding concentrations to each correspondent on a standalone basis, as well as take into account exposures to each correspondent organization as a whole.[7] In addition, the institution should be aware of exposures of its affiliates to the correspondent and its affiliates.

Credit Concentrations

Credit concentrations can arise from a variety of assets and activities. For example, an institution could have due from bank accounts, federal funds sold on a principal basis and direct or indirect loans to, or investments in, a correspondent. In identifying credit concentrations for risk-management purposes, institutions should aggregate all exposures, including but not limited to

- due from bank accounts (demand deposit accounts (DDA) and certificates of deposit (CD));
- federal funds sold on a principal basis;
- the over-collateralized amount on repurchase agreements;
- the under-collateralized portion of reverse repurchase agreements;
- net current credit exposure on derivatives contracts;
- unrealized gains on unsettled securities transactions;
- direct or indirect loans to, or for the benefit of, the correspondent;[8] and
- investments, such as trust preferred securities, subordinated debt, and stock purchases, in the correspondent.

7. Financial institutions should identify and monitor all direct or indirect relationships with their correspondents. Institutions should take into account exposures of their affiliates to correspondents and how those relationships may affect the institution's exposure. While each financial institution is responsible for monitoring its own credit and funding exposures, institution holding companies, if any, should manage their organizations' concentration risk on a consolidated basis.

8. Exclude loan participations purchased without recourse from a correspondent, its holding company, or an affiliate.

Funding Concentrations

Depending on its size and characteristics, a concentration of credit for a financial institution may be a funding exposure for the correspondent. The primary risk of a funding concentration is that an institution will have to replace those advances on short notice. This risk may be more pronounced if the funds are credit sensitive or if the financial condition of the party advancing the funds has deteriorated.

The percentage of liabilities or other measurements that may constitute a concentration of funding is likely to vary depending on the type and maturity of the funding and the structure of the recipient's sources of funds. For example, a concentration in overnight unsecured funding from one source might raise different concentration issues and concerns than unsecured term funding, assuming compliance with covenants and diversification with short- and long-term maturities. Similarly, concerns arising from concentrations in long-term unsecured funding typically increase as these instruments near maturity.

Calculating Credit and Funding Concentrations

When identifying credit and funding concentrations for risk-management purposes, institutions should calculate both gross and net exposures to the correspondent on a standalone basis and on a correspondent organization-wide basis as part of their prudent risk-management practices. Exposures are reduced to net positions to the extent that the transactions are secured by the net realizable proceeds from readily marketable collateral or are covered by valid and enforceable netting agreements. Appendix A and appendix B contain examples, which are provided for illustrative purposes only.

Monitoring Correspondent Relationships

Prudent management of correspondent concentration risks includes establishing and maintaining written policies and procedures to prevent excessive exposure to any correspondent in relation to the correspondent's financial condition. For risk-management purposes, institutions' procedures and frequency for monitoring correspondent relationships may be more or less aggressive depending on the nature, size, and risk of the exposure.

In monitoring correspondent relationships for risk-management purposes, institutions should specify internal parameters relative to what information, ratios, or trends will be reviewed for each correspondent on an ongoing basis. In addition to a correspondent's capital, level of problem loans, and earnings, institutions may want to monitor other factors, which could include but are not limited to

- deteriorating trends in capital or asset quality.
- reaching certain target ratios established by management (for example, aggregate of non-accrual and past due loans and leases as a percentage of gross loans and leases).
- increasing level of other real estate owned.
- attaining internally specified levels of volatile funding sources such as large CDs or brokered deposits.
- experiencing a downgrade in its credit rating, if publicly traded.
- being placed under a public enforcement action.

For prudent risk-management purposes, institutions should implement procedures that ensure ongoing, timely reviews of correspondent relationships. Institutions should use these reviews to conduct comprehensive assessments that consider their internal parameters and are commensurate with the nature, size, and risk of their exposure. Institutions should increase the frequency of their internal reviews when appropriate, as even well-capitalized institutions can experience rapid deterioration in their financial condition, especially in economic downturns.

Institutions' procedures also should establish documentation requirements for the reviews conducted. In addition, the procedures should specify when relationships that meet or exceed internal criteria are to be brought to the attention of the board of directors or the appropriate management committee.

Managing Correspondent Concentrations

Institutions should establish prudent internal concentration limits, as well as ranges or tolerances for each factor being monitored for each correspondent. Institutions should develop plans for managing risk when these internal limits, ranges, or tolerances are met or exceeded, either on an individual or collective basis. Contingency plans should provide a variety of actions that could be considered relative to changes in the correspondent's financial condition. However, contingency plans should not rely on temporary deposit insurance programs for mitigating concentration risk.

Prudent risk management of correspondent concentration risks should include procedures that provide for orderly reductions of correspondent concentrations that exceed internal parameters over a reasonable timeframe that is commensurate with the size, type, and volatility of the risk in the exposure. Such actions could include, but are not limited to

- reducing the volume of uncollateralized/uninsured funds.
- transferring excess funds to other correspondents after conducting appropriate reviews of their financial condition.
- requiring the correspondent to serve as agent rather than as principal for federal funds sold.
- establishing limits on asset and liability purchases from, and investments in, correspondents.
- specifying reasonable timeframes to meet targeted reduction goals for different types of exposures.

Examiners will review correspondent relationships during examinations to ascertain whether an institution's policies and procedures appropriately identify and monitor correspondent concentrations. Examiners also will review the adequacy and reasonableness of institutions' contingency plans to manage correspondent concentrations.

Performing Appropriate Due Diligence

Financial institutions that maintain credit exposures in, or provide funding to, other financial institutions should have effective risk-management programs for these activities. For this purpose, credit or funding exposures may include but are not limited to due from bank accounts; federal funds sold as principal; direct or indirect loans (including participations and syndications); trust preferred securities; subordinated debt; and stock purchases of the correspondent.

An institution that maintains or contemplates entering into any credit or funding transactions with another financial institution should have written investment, lending, and funding policies and procedures, including appropriate limits, that govern these activities. In addition, these procedures should ensure that the institution conducts an independent analysis of credit transactions prior to committing to engage in the transactions. The terms for all such credit and funding transactions should strictly be on an arm's-length basis; conform to sound investment, lending, and funding practices; and avoid potential conflicts of interest.

APPENDIX A

Calculating Respondent *Credit Exposures* on an *Organization-Wide* Basis

Respondent Bank's *Gross Credit Exposure* to a Correspondent, its Holding Company, and Affiliates

Due from DDA with correspondent	$ 50,000,000
Due from DDA with correspondent's two affiliated insured depository institutions (IDIs)	1,000,000
CDs issued by correspondent bank	1,000,000
CDs issued by one of correspondent's two affiliated IDIs	500,000
Federal funds sold to correspondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Reverse repurchase agreements	3,750,000
Net current credit exposure on derivatives[1]	250,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Gross Credit Exposure	**$117,500,000**
Total Capital	**$100,000,000**
Gross Credit Concentration	**118%**

Respondent Bank's *Net Credit Exposure* to a Correspondent, its Holding Company, and Affiliates

Due from DDA (less checks/cash not available for withdrawal and federal deposit insurance (FDI))[2]	$ 17,850,000
Due from DDA with correspondent's two affiliated IDIs (less FDI)[2]	500,000
CDs issued by correspondent bank (less FDI)	750,000
CDs issued by one of correspondent's two affiliated IDIs (less FDI)	250,000
Federal funds sold on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Under-collateralized amount on reverse repurchase agreements (less the current market value of government securities or readily marketable collateral pledged)[3]	100,000
Uncollateralized net current derivative position[1]	50,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Net Credit Exposure	**$ 80,500,000**
Total Capital	**$100,000,000**
Net Credit Concentration	**81%**

APPENDIX A—*continued*

Calculating Correspondent *Funding Exposures* on an *Organization-Wide* Basis

Correspondent's *Gross Funding Exposure* to a Respondent Bank	
Due to DDA with respondent	$ 50,000,000
Correspondent's two affiliated IDIs' due to DDA with respondent	1,000,000
CDs sold to respondent bank	1,000,000
CDs sold to respondent from one of correspondent's two affiliated IDIs	500,000
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Repurchase Agreements	1,000,000
Gross Funding Exposure	**$ 107,500,000**
Total Liabilities	**$1,350,000,000**
Gross Funding Concentration	**7.96%**

Correspondent's *Net Funding Exposure* to a Respondent, its Holding Company, and Affiliates	
Due to DDA with respondent (less checks and cash not available for withdrawal and FDI)[2]	$ 17,850,000
Correspondent's two affiliated IDIs' due to DDA with respondent (less FDI)[2]	500,000
CDs sold to correspondent (less FDI)	750,000
One of correspondent's two affiliated IDIs' CDs sold to respondent (less FDI)[2]	250,000
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	2,500,000
Under-collateralized amount of repurchase agreements relative to the current market value of government securities or readily marketable collateral pledged[3]	150,000
Net Funding Exposure	**$ 73,500,000**
Total Liabilities	**$1,350,000,000**
Net Funding Concentration	**5.44%**

Note: Respondent bank has $1 billion in total assets, comprising 10 percent of total assets or $100 million in total capital and 90 percent of total assets or $900 million in total liabilities. The correspondent has $1.5 billion in total assets, comprising 10 percent of total assets or $1.15 million in total capital and 90 percent of total assets or $1.35 billion in total liabilities.

1. There are five derivative contracts with a mark-to-market fair value position as follows: Contract 1 ($100,000), Contract 2 + $400,000, Contract 3 ($50,000), Contract 4 +$150,000, and Contract 5 ($150,000), subtotal of $250,000 fair value for the derivative contracts. Subtracting the pledged collateral's fair value of $200,000 leaves a subtotal of $50,000 or a net uncollateralized position of $50,000.

2. While temporary deposit insurance programs may provide certain transaction accounts with higher levels of federal deposit insurance coverage, institutions should not rely on such programs for mitigating concentration risk.

3. Government securities means obligations of, or obligations fully guaranteed as to principal and interest by, the U.S. government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

APPENDIX B

Calculating Respondent *Credit Exposures* on a *Correspondent-Only* Basis

Respondent Bank's *Gross Credit Exposure* to a Correspondent	
Due from DDA with correspondent	$ 50,000,000
Due from DDA with correspondent's two affiliated IDIs	0
CDs issued by correspondent bank	1,000,000
CDs issued by one of correspondent's two affiliated IDIs	0
Federal funds sold to correspondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Reverse repurchase agreements	3,750,000
Net current credit exposure on derivatives[1]	250,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Gross Credit Exposure	**$113,500,000**
Total Capital	**$100,000,000**
Gross Credit Concentration	**114%**

Respondent Bank's *Net Credit Exposure* to a Correspondent	
Due from DDA (less checks/cash not available for withdrawal and FDI)[2]	$ 17,850,000
Due from DDA with correspondent's two affiliated IDIs (less FDI)[2]	0
CDs issued by correspondent bank (less FDI)	750,000
CDs issued by one of correspondent's two affiliated IDIs (less FDI)	0
Federal funds sold on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Under-collateralized amount on reverse repurchase agreements (less the current market value of government securities or readily marketable collateral pledged)[3]	100,000
Uncollateralized net current derivative position[1]	50,000
Direct and indirect loans to, or for benefit of, a correspondent, its holding company, or affiliates	4,500,000
Investments in the correspondent, its holding company, or affiliates	2,500,000
Net Credit Exposure	**$ 77,250,000**
Total Capital	**$100,000,000**
Net Credit Concentration	**77%**

APPENDIX B—*continued*

Calculating Correspondent *Funding Exposures* on a *Correspondent-Only* Basis

Correspondent's *Gross Funding Exposure* to a Respondent	
Due to DDA with respondent	$ 50,000,000
Correspondent's two affiliated IDIs' due to DDA with respondent	0
CDs sold to respondent bank	1,000,000
CDs sold to respondent from one of correspondent's two affiliated IDIs	0
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Repurchase agreements	1,000,000
Gross Funding Exposure	**$ 103,500,000**
Total Liabilities	**$1,350,000,000**
Gross Funding Concentration	**7.67%**

Correspondent's *Net Funding Exposure* to a Respondent	
Due to DDA with respondent (less checks and cash not available for withdrawal and FDI)[2]	$ 17,850,000
Correspondent's two affiliated IDIs' due to DDA with respondent (less FDI)[2]	0
CDs sold to correspondent (less FDI)	750,000
One of correspondent's two affiliated IDIs' CDs sold to respondent (less FDI)[2]	0
Federal funds purchased from respondent on a principal basis	51,500,000
Federal funds sold to correspondent's affiliated IDIs on a principal basis	0
Under-collateralized amount on repurchase agreements (less the current market value of government securities or readily marketable collateral pledged)[3]	100,000
Net Funding Exposure	**$ 70,200,000**
Total Liabilities	**$1,350,000,000**
Net Funding Concentration	**5.20%**

Note: Respondent bank has $1 billion in total assets, comprising 10 percent of total assets or $100 million in total capital and 90 percent of total assets or $900 million in total liabilities. The correspondent has $1.5 billion in total assets, comprising 10 percent of total assets or $1.15 million in total capital and 90 percent of total assets or $1.35 billion in total liabilities.

1. There are five derivative contracts with a mark-to-market fair value position as follows: Contract 1 ($100,000), Contract 2 + $400,000, Contract 3 ($50,000), Contract 4 +$150,000, and Contract 5 ($150,000), subtotal of $250,000 fair value. Adding the collateral's fair value of $200,000 leaves a subtotal of $450,000 or a net uncollateralized position of $50,000.

2. While temporary deposit insurance programs may provide certain transaction accounts with higher levels of federal deposit insurance coverage, institutions should not rely on such programs for mitigating concentration risk.

3. Government securities means obligations of, or obligations fully guaranteed as to principal and interest by, the U.S. government or any department, agency, bureau, board, commission, or establishment of the United States, or any corporation wholly owned, directly or indirectly, by the United States.

SCOPE OF BANK SECRECY ACT/ANTI-MONEY-LAUNDERING CONTENT IN THIS MANUAL

The purpose of this section is to provide a brief introduction of the Bank Secrecy Act (BSA) and anti-money-laundering (AML) compliance program and suspicious activity reporting requirements for banks under Regulation H.[1] For additional detail on the BSA/AML program, suspicious activity reporting requirements and all other laws and regulations pertaining to the BSA, examination objectives and procedures as well as supervisory expectations, refer to the *Federal Financial Institutions Examination Council (FFIEC) BSA/AML Examination Manual*. BSA requirements and expectations are briefly covered in other sections of this manual, including "Cash Accounts," "Deposit Accounts," "Private Banking Activities," and "Managing Outsourcing Risks." Also, refer to the *BSA/AML Examination Manual* for objectives and procedures for conducting Office of Foreign Assets Control examinations.

INTRODUCTION

Banks should take reasonable and prudent steps to combat money laundering and terrorist financing and to minimize their vulnerability to the risks associated with such activities. Banks encounter legal and compliance risks when failing to implement adequate controls within their organization to comply with the BSA and other applicable AML laws and regulations. Each bank under supervision of the Federal Reserve is required to establish and maintain a BSA compliance program,[2] implement a customer identification program,[3] and identify and report suspicious activity.[4] In addition, the regulations promulgated by the Financial Crimes Enforcement Network (FinCEN), the administrator of the BSA and a bureau of the Department of the Treasury, require banks to guard against money laundering and terrorist financing.[5]

A review of the BSA/AML compliance program is required at each full-scope examination of an insured depository institution and is an important aspect of safety-and-soundness examinations.[6] In supervising state member banks, evaluating the adequacy of the BSA/AML compliance program would generally help inform the rating of the management component of the Uniform Financial Institutions Rating System. The management rating reflects the capability of the board of directors and management, in their respective roles, to identify, measure, monitor, and control the risks of a bank's activities and to ensure a safe, sound, and efficient operation in compliance with applicable laws and regulations. The impact of BSA/AML compliance problems on the management rating should be assessed on a case-by-case basis, and will depend on the severity of the issues at the bank. Examiners evaluate the adequacy of a bank's BSA/AML compliance program relative to its risk profile and its compliance with applicable laws and regulations, recognizing that banks vary in focus and complexity, and that these differences create for each bank a unique risk profile.[7] In addition to influencing ratings, consideration of a bank's effectiveness in combating money laundering activities is a required component of the application process.[8] As such, BSA/AML problems can have an impact on a bank's strategic plan.

Certain federal and state government agencies play a critical role in implementing BSA regulations, developing examination guidance, ensuring compliance with the BSA, and enforcing the BSA. These agencies include the U.S. Treasury, FinCEN, various state banking agencies and the federal banking agencies.[9] The federal

1. Federal Reserve supervised institutions that are subject to the BSA include state member banks (Regulation H, 12 CFR 208), bank holding companies (Regulation Y, 12 CFR 225), Edge and agreement corporations, and foreign banking organizations operating in the United States (Regulation K, 12 CFR 211).
2. 12 CFR 208.63.
3. 12 CFR 208.63(b)(2).
4. 12 CFR 208.62.
5. 31 CFR 1010 (general provisions) and 31 CFR 1020 (rules for banks).
6. 12 USC 1818(s)(2).
7. See SR letter 19-11, "Joint Statement on Risk-Focused Bank Secrecy Act/Anti-Money Laundering Supervision."
8. See SR letter 14-2, "Enhancing Transparency in the Federal Reserve's Applications Process," and SR letter 02-8, "Implementation of Section 327 of the USA PATRIOT Act in the Applications Process," for more information.
9. The federal banking agencies include the Board of

banking agencies may use their authority, as granted under section 8 of the Federal Deposit Insurance Act (FDIA), to enforce compliance with appropriate banking rules and regulations, including compliance with the BSA. FinCEN, as administrator of the BSA, may also pursue civil enforcement actions when warranted.

REGULATION H

The Board's Regulation H requires a state member bank to establish a BSA compliance program and file suspicious activity reports (SAR). In accordance with the Board's regulation, a bank's BSA compliance program must be in writing and approved by its board of directors, with the approval noted in the board minutes. As part of its overall BSA compliance program, a bank is required to develop and implement a customer identification program. At a minimum, the BSA compliance program must

- provide for a system of internal controls to assure ongoing compliance;
- provide for independent testing for compliance to be conducted by bank personnel or by an outside party;
- designate an individual or individuals responsible for coordinating and monitoring day-to-day compliance; and
- provide training for appropriate personnel.

The Board's regulations also require a bank to report certain activity to law enforcement that may be useful to the government in criminal, tax, or regulatory proceedings. A bank must electronically file a SAR with FinCEN no later than 30 calendar days in the following circumstances of suspected unlawful activity:

- insider abuse involving any amount;
- violations aggregating $5,000 or more in which a suspect can be identified;
- violations aggregating $25,000 or more regardless of a potential suspect; or
- transactions aggregating $5,000 or more that involve potential money laundering or violations of the BSA.

Suspicious activity reporting is one of the many tools that law enforcement authorities use to combat money laundering, terrorist financing, and other financial crimes. A SAR and any information that would reveal the existence of a SAR are confidential, except as is necessary to fulfill BSA obligations and responsibilities.

For comprehensive information regarding the BSA Compliance Program and SAR filing requirements, including examination procedures, please refer to the FFIEC *Bank Secrecy Act/Anti-Money Laundering Examination Manual*.

COMMUNICATIONS OF SUPERVISORY FINDINGS ABOUT COMPLIANCE WITH THE BSA

When examiners identify supervisory concerns related to a bank's BSA/AML compliance in the course of an examination, they should communicate those concerns as outlined in this manual in the section entitled "Examination Strategy and Risk-Focused Examinations." Generally, findings would be contained in the report of examination or in other formal communication. This includes Matters Requiring Immediate Attention (MRIAs), Matters Requiring Attention (MRAs), and violations of law.

For more serious issues of noncompliance, the Federal Reserve Board has a broad range of formal and informal enforcement powers. For more information on enforcement actions, refer to the enforcement actions section of this manual and consult with staff of the Board of Governors.

REPORTING OF SUSPECTED CRIMINAL VIOLATIONS BY FEDERAL RESERVE

The Board has outlined procedures for the referral to law enforcement of potential criminal activity identified during the supervisory process through the filing of a SAR with FinCEN. The Board has also established steps that Board and Reserve Bank staff should follow with respect to the reporting of suspicious activity.

Examiners should focus on whether a financial institution has an effective SAR decision-making process, not individual SAR decisions. Examiners may review individual SAR decisions as a means to test the effectiveness of the SAR monitoring, detecting, reporting, and deci-

Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

sionmaking process. If, for example, during the course of an examination an examiner determines that a financial institution's failure to file a SAR is indicative of significant suspected illegal activity or deficient SAR processes that warrants criticism, these findings should be expressly communicated to the bank's management. The examiner should document the situation, including any response or corrective action taken by management to address the examiner's concerns. In general, examiners should also cite the bank in the report of examination (ROE) for an apparent violation of law. If the suspicious activity involves an insider, an examiner must not disclose the existence of a SAR filing to the subject of the SAR, who may have access to the ROE or other correspondence. In these instances, examiners should consult Board staff to determine the appropriate course of action.

Limited circumstances may exist where a financial institution is unwilling or unable to report suspicious activity to law enforcement. The Federal Reserve has developed specific procedures for examiners for requesting consideration of a SAR filing with law enforcement. The Board's Legal Division has primary responsibility for the referral of criminal matters for the Federal Reserve System to the appropriate law enforcement authorities. The Board may make a referral to law enforcement by filing a SAR with FinCEN. Importantly, the Board's ability to file a SAR is only one method of making a referral to law enforcement and other referral methods may be more appropriate depending on the facts and circumstances. For example, the Board's Legal Division may contact the U.S. Department of Justice directly to make a referral in certain circumstances. In determining whether the Board should file a SAR, staff from the Board's Legal Division may consider a variety of factors, including any prior communications with law enforcement regarding the activity.

INTRODUCTION

The Depository Institution Management Interlocks Act (Interlocks Act), as implemented by Regulation L (12 CFR 212) and Subpart J of Regulation LL (12 CFR 238.91-.99), prohibits a management official of a depository institution or depository institution holding company from serving simultaneously as a management official of another depository organization if the organizations are not affiliated and both either are very large or are located in the same local area.[1] The Interlocks Act fosters competition among depository organizations by prohibiting interlocking relationships of management officials where the management interlock likely would have an anticompetitive effect. The Board's regulations implementing the Interlocks Act apply to management officials of state member banks, depository institution holding companies, and their affiliates.

PROHIBITIONS

The Interlocks Act and the Federal Reserve Board's implementing regulations generally prohibit management interlocks in the following three situations, unless the interlock is otherwise exempted:

1. *Community prohibition:* Restricts management interlocks between unaffiliated depository organizations if the organizations in question (or a depository institution affiliate thereof) have offices in the same "community" as defined in the regulations.
2. *Relevant metropolitan statistical area (RMSA) prohibition:* Restricts management interlocks between unaffiliated depository organizations if each has total assets of $50 million or more, and both depository organizations, or any of their depository institution affiliates, have offices in the same RMSA.
3. *Major assets prohibition:* Restricts management interlocks between two unaffiliated depository organizations, each with total assets exceeding $10 billion (or any affiliate of such organizations), regardless of the location of the two depository organizations.[2]

STATUTORY AND REGULATORY EXEMPTIONS

The Interlocks Act includes several specific exemptions from the general interlocks prohibitions. Under these statutory exemptions (codified in 12 USC 3204 and 3205, and set forth in 12 CFR 212.4 and 12 CFR 238.94), the Interlocks Act permits a management interlock for the following organizations and persons:

- an Edge or agreement corporation;
- a depository organization in formal liquidation or a similar type situation;
- a credit union being served by a management official of another credit union;
- a depository institution that does not do business in the United States except as an incident to its activities outside the United States;
- a state-chartered savings and loan guaranty corporation;
- a Federal Home Loan Bank or other bank organized solely for the purpose of serving depository institutions or solely for the purpose of providing securities clearing services and related services related to other depository institutions;
- a depository organization that is closed or is in danger of closing as determined by the appropriate federal depository institution's regulatory agency and is acquired by another depository organization; or
- a diversified savings and loan holding company (as defined in section 10(a)(1)(F) of the Home Owners' Loan Act (12 USC 1467a(a)(1)(F)) with respect to the service of a director of such company who also is a director of an unaffiliated depository organization.

The Interlocks Act also provides general authority for the Federal Reserve Board to

1. The Board's rules define "depository organizations" to include depository institutions and depository holding companies. The Board has authority under the Interlocks Act to prescribe regulations necessary to carry out the Interlocks Act with respect to state member banks, bank holding companies, and savings and loan holding companies (12 USC 3207(2)). For more information on management official interlocks at savings and loan holding companies, see the Federal Reserve Board's Regulation LL (12 CFR 238 subpart J).

2. 84 *Fed. Reg.* 54,465 (October 10, 2019).

establish exemptions through its regulations. The Federal Reserve Board has used this authority to establish the small market share exemption and other general exemptions.

Under the small market share exemption (12 CFR 212.5 and 12 CFR 238.95), a management interlock is permissible if (1) the interlock is not prohibited by major asset prohibition, and (2) the depository organizations (and their depository institution affiliates) hold, in the aggregate, no more than 20 percent of the deposits in each RMSA or community in which both depository organizations (or their depository institution affiliates) have offices. The amount of deposits is determined by reference to the most recent annual Summary of Deposits published by the Federal Deposit Insurance Corporation for the RMSA or community. Small market share exemptions are automatic, contingent on the interlocked depository organizations maintaining sufficient records to support the determination of eligibility and must be reconfirmed on an annual basis.

In addition, the Federal Reserve Board may exempt a prohibited interlock in response to an application by a depository organization if the Federal Reserve Board finds that the interlock would not result in a monopoly or substantial lessening of competition, and would not present safety and soundness concerns. Section 212.6(b) of Regulation L, as well as section 238.96(b) of Regulation LL, identifies certain proposals that are presumed not to result in a monopoly or substantial lessening of competition. These are

- depository organizations primarily serving low- and moderate-income areas,
- depository organizations controlled or managed by members of a minority group or by women,
- depository institutions that have been chartered for fewer than two years, and
- depository organizations in "troubled condition" as defined in the Federal Reserve Board's Regulation Y.[3]

An exemption obtained pursuant to 12 CFR 212.6(a) or 238.96(a) may continue for so long as it does not result in a monopoly or substantial lessening of competition, or is unsafe or unsound. If the Federal Reserve Board grants an interlock exemption in reliance upon a presumption listed at 12 CFR 212.6(b) or 12 CFR 238.96(b), the interlock may continue for three years, unless otherwise provided by the Board in writing.

CHANGE IN CIRCUMSTANCES

A management official must terminate their service or apply for an exemption if a change in circumstances causes the management interlock to become prohibited (see 12 CFR 212.7 and 238.97). A change in circumstances may include an increase in asset size of a depository organization, a change in the delineation of the RMSA or community, the establishment of an office, an increase in the aggregate deposits of the depository organization, or an acquisition, merger, consolidation, or reorganization of the ownership structure of a depository organization that causes a previously permissible interlock to become prohibited.

A management interlock that becomes prohibited due to a change in circumstances under 12 CFR 212.7 or 12 CFR 238.97 may continue for 15 months following the date of the change in circumstances. The Federal Reserve Board may shorten this period under appropriate circumstances.

3. The Board's Regulation Y (12 CFR 225.71) states that troubled condition for a regulated institution means an institution that (1) has a composite rating, as determined in its most recent report of examination or inspection, of 4 or 5 under the CAMELS rating system or the Federal Reserve Bank Holding Company rating system; (2) is subject to a cease-and-desist order or formal written agreement that requires action to improve the financial condition of the institution, unless otherwise informed in writing by the Board or Reserve Bank; or (3) is informed in writing by the Board or Reserve Bank that it is in troubled condition for purposes of the requirements of subpart H of Regulation Y on the basis of the institution's most recent report of condition or report of examination or inspection, or other information available to the Board or Reserve Bank. Note that with the Federal Reserve Bank Holding Company rating system, there is no presumption that a firm rated "Deficient-1" would be deemed to be in "troubled condition." Whether a firm subject to the Federal Reserve Bank Holding Company rating system rated "Deficient-1" receives a "troubled condition" designation will be determined by the facts and circumstances at that firm. However, firms rated "Deficient-1" due to financial weaknesses in either capital or liquidity would be more likely to be deemed in "troubled condition" than firms rated "Deficient-1" due solely to issues of governance or controls. See 83 *Fed. Reg.* 58,724 (November 21, 2018) and 84 *Fed. Reg.* 4309 (February 15, 2019) for more information.

Regulation O: Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks

Effective date April 2020

Section 6050.1

PURPOSE AND APPLICABILITY

The Federal Reserve Board's Regulation O (12 CFR 215) implements many of the laws pertaining to extensions of credit by banks to their insiders.[1] Regulation O was issued pursuant to Sections 22(g) and 22(h) of the Federal Reserve Act. Regulation O is designed to mitigate the potential for conflicts of interest and self-dealing by individuals who may be in a position to influence a bank's lending decisions. The regulation limits the amount and type of credit that a member bank may extend to an insider and includes reporting and recordkeeping requirements for a member bank to track and report such activity. The regulation requires that extensions of credit to executive officers, directors, principal shareholders, and their related interests be made substantially on the same terms and follow credit underwriting procedures that are not less stringent than those prevailing at the time for comparable transactions with persons not covered by the regulation. In addition, such extensions of credit should not involve more than the normal risk of repayment or present other unfavorable features. Regulation O also imposes individual and aggregate lending limits and prior approval requirements for certain extensions of credit.

Moreover, certain extensions of credit to executive officers of member banks are subject to additional restrictions. In addition, a member bank is prohibited from making payments of overdrafts to directors or executive officers absent a written, preauthorized plan for the overdraft to be treated as an extension of credit that bears interest or a transfer of funds from another account at the bank.

With regards to applicability, the Federal Reserve's Regulation O governs any extension of credit by a member bank to an executive officer, director, or principal shareholder of

1. The member bank,
2. Any company of which the member bank is a subsidiary, and
3. Any other subsidiary of that company.

1. This section summarizes and explains the rule, as amended, but is not a substitute for the rule itself.

The regulation also applies to any extension of credit by a member bank to the related interests of executive officers, directors, or principal shareholders, including companies controlled by such a person and political or campaign committees that benefit or are controlled by such a person.

Extensions of credit by a member bank to its executive officers, directors, principal shareholders, and their related interests, as well as other items related to Regulation O, are reported on Schedule RC-M of the Consolidated Reports of Condition and Income (Call Report). For more information on reporting, refer to the appropriate Call Report form and instructions.

EXTENSION OF CREDIT (12 CFR 215.3)

Regulation O defines an "extension of credit" to include the making or renewal of any loan, a granting of a line of credit, or an extending of credit in any manner whatsoever including

1. A purchase under repurchase agreement of securities, other assets, or obligations;
2. An advance by means of an overdraft, cash item, or otherwise;
3. Issuance of a standby letter of credit (or other similar arrangement regardless of name or description) or an ineligible acceptance;
4. An acquisition by discount, purchase, exchange, or otherwise of any note, draft, bill of exchange, or other evidence of indebtedness upon which an insider may be liable as maker, drawer, endorser, guarantor, or surety;
5. An increase of an existing indebtedness, but not if the additional funds are advanced by the bank for its own protection for (a) accrued interest or (b) taxes insurance, or other expenses incidental to the existing indebtedness;
6. An advance of unearned salary or other unearned compensation for a period in excess of 30 days; and
7. Any other similar transaction as a result of which a person becomes obligated to pay money (or its equivalent) to a bank, whether the obligation arises directly or indirectly, or

because of an endorsement on an obligation or otherwise, or by any means whatsoever.[2]

The requirements of Regulation O apply at the time a loan or extension of credit is made, which is the time the bank enters into a binding commitment to make the extension of credit.[3] Thus, loans or extensions of credit that were made to an individual before they became an insider are grandfathered, as long as they were made in good faith and not in contemplation of the individual becoming an insider. If such loans exceed the amount permitted by Regulation O, they will be considered nonconforming rather than a violation of Regulation O. However, if the loans are nonconforming, no new extensions of credit subject to Regulation O may be made to the individual, and existing loans may not be renewed, except in compliance with Regulation O.[4]

LIMITS ON EXTENSIONS OF CREDIT TO INSIDERS (12 USC 375B AND 12 CFR 215.4)

Terms and Creditworthiness

Regulation O applies limits and prohibitions to extensions of credit made by a member bank to all insiders—executive officers, directors, and principal shareholders, and the related interests of these persons—including insiders of affiliates. Regulation O specifies that a member bank may not extend credit to an insider of the bank or an insider of the bank's affiliates unless the extension is made on substantially the same terms as other loans, in accordance with underwriting procedures used for other loans for comparable transactions, does not involve more than the normal risk of repayment, and does not present other unfavorable terms. Exceptions are provided for certain extensions of credit made pursuant to a benefit or compensation program that is widely available to all employees of the member bank and does not give preference over employees that are not insiders.

Prior Approval

Regulation O requires prior approval by the member bank's board of directors for extensions of credit that exceed the higher of $25,000 or 5 percent of the bank's unimpaired capital stock and surplus.[5] Such approval should be documented within the board's minutes, and the insider who would receive the loan should abstain from the board's approval process. In addition, if the extension of credit exceeds $500,000, it must follow the prior approval procedure.

Individual and Aggregate Lending Limits

Extensions of credit to insiders are restricted on an individual and aggregate level. No member bank may extend credit to any insider of the bank or insider of its affiliates in an amount that, when aggregated with the amount of all other extensions of credit by the member bank to that person and to all related interests of that person, exceeds the lending limit of the member bank specified in 12 CFR 215.2(i). For loans that are not fully secured, this amount is 15 percent of the bank's unimpaired capital stock and unimpaired surplus. An additional 10 percent of the bank's unimpaired capital and unimpaired surplus is added for loans that are fully secured by readily marketable collateral having a market value—as determined by reliable and continuously available price quotations—that is at least equal to the amount of the loan. Additionally, a member bank may not extend credit to any insider of the bank or insider of its affiliates if the extension of credit is in an amount that, when aggregated with the amount of all outstanding extensions of credit by that bank to all insiders, exceeds the bank's unimpaired capital and unimpaired surplus.

2. The Dodd-Frank Wall Street Reform and Consumer Protection Act added to the definition of an "extension of credit" an insured depository institution's credit exposure to a person arising from a derivative transaction, repurchase agreement, reverse repurchase agreement, securities lending transaction, or securities borrowing transaction. Refer to Regulation O for information on what an "extension of credit" does not include and for the other regulatory provisions.

3. 12 CFR 215.3(d).

4. For more information, see 22 *Fed. Res. Bull.* 121 (1936); *Fed. Res. Reg. Serv.* 3-1036; letter of J. Virgil Mattingly, Jr., General Counsel, Board of Governors of the Federal Reserve System (September 16, 1992), 1992 WL 693697 (FRB). See also the OCC's Interpretive Letter #1096 (March 20, 2008).

5. 12 CFR 215.4(b).

Overdrafts

In addition, a member bank is prohibited from paying an overdraft of an executive officer or director unless the overdraft is made pursuant to a written, preauthorized, interest-bearing extension-of-credit plan that specifies a method of repayment, or a written, preauthorized transfer of funds from another account of the insider at the bank. This prohibition does not apply to the payment of inadvertent overdrafts in aggregate of $1,000 or less, as long as the account was not overdrawn for more than five business days and the standard overdraft fee was charged.

EXTENSIONS OF CREDIT TO EXECUTIVE OFFICERS (12 USC 375A AND 12 CFR 215.5)

Regulation O imposes additional limits on extensions of credit to executive officers of member banks (but not to their related interests and not to executive officers of affiliates). Aggregate loans to an executive officer may not exceed the higher of $25,000 or 2.5 percent of the institution's unimpaired capital and surplus but in no event more than $100,000.

However, a member bank may extend credit to an executive officer of a member bank in any amount to finance or refinance

- the purchase, construction, maintenance, or improvement of a single residence of an executive officer if the loan is secured by a first lien on the residence that the executive officer owns (or expects to own after the extension of credit); or
- the education of their children.

An executive officer may have only one of each such loan from the member bank outstanding at a time. Certain secured loans may be permitted (12 CFR 215.5(c)(3)) in excess of the lending limit set by 12 CFR 215.5(c)(4). It is important to note that, although mortgage and educational loans are not subject to limitation under 12 USC 375a and 12 CFR 215.5, aggregate loans to an individual executive officer of a member bank (including mortgage and education loans) collectively are limited by 12 USC 375b and 12 CFR 215.4.

INSIDER USE OF A BANK-OWNED CREDIT CARD

Federal Reserve Board staff issued a May 22, 2006, legal opinion in response to a request for clarification from the Federal Deposit Insurance Corporation (FDIC) on the application of the Board's Regulation O to credit cards that are issued to bank insiders for the bank's business purposes. The FDIC asked whether, and under what circumstances, an insider's use of a bank-owned credit card would be deemed an extension of credit by the bank to the insider for purposes of Regulation O. The Federal Reserve Board staff's legal opinion applies only to the specific issues and circumstances described in the letter and does not address any other issues or circumstances. For more information, see the Federal Reserve Board's legal opinion on its public website.

SUPERVISORY CONSIDERATIONS

Business transactions between a member bank and insiders require close supervisory review. Many of these transactions are soundly structured and have a legitimate business purpose so that all parties are treated equitably. However, absent the protection of an arm's-length transaction, the potential for or appearance of abuse is greater and necessitates intensified review. A member bank's extension of credit to an insider may be considered abusive or self-serving if its terms are unfavorable to the lender or if the credit would not have been extended on the same terms to a non-insider. That is, it would be improbable that each party to the credit would have entered into the credit transaction under the same terms if the relationship did not exist.

Examiners should pay close attention to credit extensions of a member bank to its insiders and their related interests. Extensions of credit to insiders or their related interests should be reviewed to determine whether the amount of credit extended, both to a single borrower and in aggregate to all borrowers, conform to the provisions of Regulation O. Furthermore, examiners should review the terms of the credit, particularly interest rate and collateral terms, to ensure no preferential treatment was given, and the credit does not involve more than a normal repayment risk. Documentation of comparable transactions must be available for examiner review in order to determine that the terms of substantially the same as third-party transactions and that the underwriting standards are not less stringent for insiders.

Examples of preferential treatment include

- lower interest rates than those other customers pay on similar type of loans;
- lower collateral requirements or unwarranted unsecured extensions of credit;
- longer maturities than typical for the nature and purpose of the loan;
- no personal guarantee of corporate debt if required from all other bank customers;
- a loan allowed for a purpose that would not be extended to other bank customers; and
- no requirement for a financial statement on the insider or other documentation that would be requested of other bank customers.

The examination procedures (ED modules) provide more information on assessing a member bank's compliance with Regulation O. If a credit extension appears to circumvent the intent of Regulation O, examiners should discuss the credit extension with the member bank's management to obtain additional information on the terms of the credit. Examiners should assess whether the potentially noncompliant credit extension was an inadvertent instance of noncompliance with Regulation O as well as whether the member bank incurred any losses as a result of the credit extension. The examiner and examiner-in-charge (EIC) should discuss with the member bank's management its plans to bring any noncompliant credit extension into compliance and the need for management to improve controls to prevent further instances of inadvertent noncompliance. Examiners should disclose the noncompliance credit extension(s) and any corresponding matters requiring attention in the report of examination, as appropriate.

For more serious apparent violations of Regulation O, such as intentional or systematic reporting issues, the EIC should raise the issue to Reserve Bank management. Examiners should also notify Reserve Bank management if it is unclear whether the borrower is subject to Regulation O. In these instances, Reserve Bank management will coordinate any necessary discussions with Reserve Bank Legal and/or Board Legal staff. If it is determined that supervisory corrective action is required, the EIC and Reserve Bank management will draft the informal or formal supervisory action in consultation with the Board enforcement staff. See also this manual's section on Formal and Informal Supervisory Actions for more information.

Status of Certain Investment Funds and Their Portfolio Investments for Purposes of Regulation O

The popularity of mutual funds, exchange traded funds, and similar index-based investment products has resulted in several large asset management companies becoming principal shareholders of a number of banks. These funds and products have triggered the Regulation O presumption of control of a related interest over an increasing number of companies in the asset managers' portfolios.

The Federal Reserve Board, the FDIC, and the OCC (agencies) issued an interagency statement in 2019 to explain that the agencies will exercise discretion in not taking enforcement action against banks or asset managers, which become principal shareholders of banks, with respect to certain extensions of credit by banks that otherwise would violate Regulation O. See SR-19-16 for more information.

As detailed in the statement, the agencies are providing this temporary relief while the Board, in consultation with the other agencies, considers whether to amend Regulation O to address this issue. The relief covers extensions of credit to fund complex-controlled portfolio companies only, and does not extend to any extension of credit to principal shareholder fund complexes. The statement provides more specific information on the application of Regulation O in this specific context.

Objective: Assess the bank's compliance with the Federal Reserve Board's Regulation O (12 CFR 215).

Regulation O governs any extension of credit by a bank to an insider, a term defined to include a director, executive officer, or principal shareholder of the bank, the bank holding company of the bank and any other subsidiary of the bank holding company. The regulation also applies to an extension of credit to insiders' related interests and prohibits preferential lending by a bank to insiders of another bank when there is a correspondent account relationship between the banks.

The purpose of Regulation O is to prevent insiders from using their positions and leverage to procure loans on more preferential terms or conditions than would otherwise be available to other customers of the bank.

Regulation O is made applicable to state nonmember banks by Section 18(j)(2) of the Federal Deposit Insurance Act. See also 12 CFR section 337.3 of FDIC Regulations.

Savings Associations: Savings associations, both state and Federal, are subject to Regulation O pursuant to section 11(b) of the Home Owners Loan Act (12 USC section 1468(b)). See also 12 CFR section 215.12.

PRELIMINARY REVIEW

1. Identify previous concerns by reviewing prior examination reports, file correspondence, and audits.
2. Review board minutes since the previous examination and note all discussions and votes related to borrowings of insiders and their related interests.
3. Request a list of extensions of credit to insiders and their related interests and review all internal reports used to monitor extensions of credit to insiders and their related interests.
4. Review internal audits and loan reviews pertaining to insider borrowings, and assess remedial actions taken by management to address prior audit, loan review, or examination findings.

POLICY CONSIDERATIONS

5. Determine whether the bank adopted written policies and procedures to address Regulation O requirements, such as
   - appropriately identifying executive officers, directors, principal shareholders, and their related interests of the bank and its affiliates as defined by section 215.2 of Regulation O;
   - appropriately identifying all extensions of credit related to insiders as defined by section 215.3 of the regulation, including those considered extensions under the tangible economic benefit rule;
   - ensuring extensions of credit to insiders are made at arm's length on substantially the same terms and following underwriting procedures that are not less stringent than those used for comparable transactions, do not give preference to any insider over other employees, and do not involve more than normal risk of repayment or present other unfavorable features as set forth in section 215.4(a);
   - ensuring appropriate prior approval of extensions of credit to insiders of the bank and its affiliates as delineated in section 215.4(b);
   - accurately aggregating extensions of credit to ensure compliance with individual and aggregate lending limits designated in sections 215.4(c) and 215.4(d), respectively;
   - identifying and monitoring transaction accounts of directors and executive officers of the bank and its affiliates to ensure compliance with section 215.4(e);
   - ensuring that all extensions of credit to executive officers of the bank do not exceed the regulatory limits as prescribed in section 215.5;
   - maintaining appropriate records necessary for compliance with section 215.8;
   - appropriately disclosing credit extended from banks to insiders and their related interests as mandated by section 215.9 (when requested in writing); and
   - ensuring that directors and executive officers report annually to the board any

outstanding credit secured by the shares of the bank not traded publicly (section 215.10).

MANAGEMENT INFORMATION SYSTEMS

6. Determine whether management information systems accurately identify and aggregate extensions of credit to insiders and their related interests.

SECTION 215.4 (A)—GENERAL PROHIBITIONS—TERMS AND CREDITWORTHINESS

Applies to insiders of the bank (executive officers, directors, principal shareholders, and their related interests), and to insiders of the bank's affiliates in most circumstances.

A bank may not extend credit to any insider of the bank or to an insider of its affiliates unless the extension of credit is made on substantially the same terms and conditions, and with underwriting standards that are not less stringent, than those terms and standards prevailing at the time for comparable transactions by the bank to non-insider customers.

In addition to the not-more-favorable terms requirements, an extension of credit to a bank insider or an insider of a bank affiliate may not involve more than the normal risk of repayment, or present other unfavorable features.

7. Review loans to insiders and their related interests and review a sample of similar loans to non-insiders. Determine whether insider loans were granted on terms and conditions more favorable than comparable transactions to non-insiders or other employees.

8. Determine whether any loans to insiders involved more than the normal risk of repayment or present other unfavorable features when compared with loans to non-insiders or other employees.

SECTION 215.4 (B)—PRIOR APPROVAL

Applies to insiders of the bank and in most circumstances to insiders of the bank's affiliates. Approval by the board is not required under this section for an extension of credit made pursuant to a line of credit approved under this section within 14 months of the date of the extension of credit. However, this extension of credit must still comply with section 215.4(a).

A majority of the board of directors must approve any extension of credit to an insider that, when aggregated with all other extensions of credit to that insider and their related interest, exceeds the higher of $25,000 or 5 percent of unimpaired capital and surplus, not to exceed $500,000 except by complying with the requirements of 215.4(b).

9. List any insiders and related interests to whom the bank has extended aggregate credit exceeding the threshold calculated above. For relevant time periods, review board minutes to ensure that those extensions exceeding the prior approval threshold were
   - pre-approved by a majority of the bank's board of directors, and
   - approved without the direct or indirect participation of the insider obtaining the loan.[1]

SECTION 215.4(C)—INDIVIDUAL LENDING LIMIT

Applies to insiders of the bank and in most circumstances to insiders of the bank's affiliates.

No bank may extend credit to an insider that, when aggregated with all other extensions to that insider and their related interests, exceeds the legal lending limit of the institution. The legal lending limit is generally 15 percent of capital plus an additional 10 percent if the additional 10 percent is fully secured by readily marketable collateral. The 10 percent limitation is separate from and in addition to the initial 15 percent limitation.

When state law establishes a lending limit for a bank that is lower than the amount permitted

1. Minutes typically reflect that the affected insiders excused themselves during the discussions and abstained from voting on those extensions of credit.

in this calculation, the state's lending limit is the applicable lending limit for the bank.

10. Determine whether managerial reports documenting loans to insiders and their related interests accurately aggregate extensions of credit. Review totals for each insider to assess compliance with calculated limits. Verify that loans segregated in the 10 percent category are fully secured by readily marketable collateral having a reliable and continuously available market value.
11. Determine whether loans to insiders and their related interests are not subject to exceptions to the Individual Lending Limit as outlined in Appendix to Part 215—Section 5200 of the Revised Statutes Total Loans and Extensions of Credit.

SECTION 215.4(D)—AGGREGATE LENDING LIMIT

Applies to insiders of the bank and in most circumstances to insiders of the bank's affiliates.

A bank may not extend credit to any insider of the bank or insider of its affiliates unless the amount of the extension of credit, when aggregated with the amount of all outstanding extensions of credit to all such insiders, does not exceed the bank's unimpaired capital and unimpaired surplus.

A bank with total deposits of less than $100 million may, by annual board resolution, adopt a higher aggregate lending limit not to exceed two times the bank's unimpaired capital and surplus if

- *the board of directors determines that such a high limit is consistent with prudent, safe and sound banking practices in light of the bank's experience in lending to its insiders and is necessary to attract or retain directors or to prevent restricting the availability of credit in small communities;*
- *the resolution sets forth the facts and reasoning on which the board of directors bases the finding, including the amount of the bank's lending to its insiders as a percentage of the bank's unimpaired capital and unimpaired surplus as of the date of the resolution;*
- *the bank meets or exceeds all applicable capital requirements established by the appropriate federal banking agency; and the bank received a satisfactory composite rating in its most recent report of examination.*

12. Determine whether extensions of credit to insiders and their related interests do not exceed the bank's unimpaired capital and unimpaired surplus or that those banks with less than $100 million in total deposits meet the criteria for the exception outlined above.
13. For banks that have adopted a resolution authorizing a higher limit but subsequently fail to meet the four requirements, verify that they have not extended any additional credit (including a renewal of any existing extension of credit) to any insider of the bank or its affiliates, unless such extensions of credit do not exceed the bank's unimpaired capital and surplus.
14. Verify that loans to insiders and their related interests are not subject to exceptions to the Aggregate Lending Limit as outlined in Appendix to Part 215—Section 5200(c) of the Revised Statutes Total Loans and Extensions of Credit.

SECTION 215.4(E)—OVERDRAFTS—TRANSACTION TESTING/SAMPLE REVIEW

Applies to executive officers and directors of the bank and in most circumstances those of its affiliates. It does not apply to related interests. It does not apply to principal shareholders, unless they are also an executive officer or director.

No bank may pay an overdraft of an executive officer or director of the bank or an executive officer or director of its affiliates on an account at the bank, unless the payment of funds is made in accordance with a written, preauthorized, interest-bearing extension-of-credit plan that specifies a method of repayment, or a written, preauthorized transfer of funds from another account of the account holder at the bank.

Certain inadvertent overdrafts on an executive officer or director account that total $1,000 or less are allowed provided

- *the account is not overdrawn for more than five business days, and*
- *the bank charges the same fee charged to any other customer of the bank in similar circumstances.*

15. Review overdraft, bounce protection, check kiting, uncollected funds, and large item reports for activity related to overdrafts of executive officers and directors of the bank and its affiliates. Determine whether any overdrafts were paid in contravention of established bank policies, such as no pay, all pay, or ad hoc overdraft arrangements.
16. Determine whether the bank has established written, preauthorized, interest bearing credit plans (overdraft protection) with executive officers or directors of the bank or executive officers or directors of its affiliates. Ensure that these plans specify a method of repayment and verify that the credit plans are performing as agreed.
17. Determine whether the bank has established written, preauthorized agreements for fund transfers from another account in the event of an overdraft. Determine whether any overdrafts noted in director or executive officers' accounts are covered by a transfer agreement.

ADDITIONAL RESTRICTIONS ON LOANS TO EXECUTIVE OFFICERS OF BANKS (SECTION 215.5)

Only applies to executive officers of the bank.

Aggregate loans to an executive officer may not exceed the higher of $25,000 or 2.5 percent of unimpaired capital and surplus and in no event more than $100,000, as defined in section 215.5.

There are no dollar limits on loans for the education of children or for the purchase, construction, maintenance, or improvement of a single residence if secured by a first lien and the residence is owned by the officer. Furthermore, there are no dollar limits on loans secured by U.S. government and agency securities or by a deposit account in the respective bank. The aggregate calculation should also exclude credit card debt of $15,000 or less [section 215.3(b)(5)] and indebtedness of $5,000 or less arising from an interest bearing overdraft credit plan [section 215.3(b)(6)].

18. Review extensions of credit made to executive officers or any partnerships in which one or more executive officers are partners, and individually or together, hold a majority interest, to determine that qualifying loans were made within applicable limits.

19. Review extensions of credit to executive officers and determine whether the loans were promptly reported to the board of directors. (Any extension of credit by a bank to an executive officer must be promptly reported to the bank's board of directors, and comply with the terms and creditworthiness requirements of section 215.4(a).) See also section 215.5(d).

20. Review loans files and other relevant documentation to ensure that reportable transactions were preceded by the submission of a detailed, current financial statement of the officer and include a condition that the extension will, at the option of the bank, become due and payable at any time that the officer is indebted to any other bank or banks in an aggregate amount greater than the limit for 215.5(c). See also section 215.5(d).

RECORDKEEPING AND REPORTING REQUIREMENTS—SECTIONS 215.8, 215.9, AND 215.10

Applies to insiders of banks and their affiliates; however, there are certain exclusions for directors and executive officers of affiliates. See section 215.2 for specific conditions under which directors and executive officers of affiliates can be excluded.

21. Determine whether the recordkeeping method adopted by the bank accurately maintains records of extensions of credit to insiders and their related interests as required by section 215.8.

22. Verify that the bank, upon receipt of written request from the public, has made available the names of each of its executive officers and principal shareholders to whom, or to whose related interests, the bank had an outstanding extension of credit, that when aggregated with all other outstanding extensions, equaled or exceeded 5 percent of capital and surplus, or $500,000, whichever amount is less. Verify that requests for this information and the disposition of such

requests are maintained for at least two years.[2]

23. If applicable, determine whether executive officers and directors of a bank whose shares are not publicly traded report annually to the board of directors of the bank any outstanding credit secured by shares of the bank. This requirement is only applicable to shares of bank stocks that are not publicly traded (section 215.10). (Note: Applies to executive officers and directors of the bank only.)
24. Determine whether extensions of credit from a correspondent bank to a respondent bank insider and from a respondent bank to a correspondent bank insider, as well as accounts opened by banks with a loan to an insider of a correspondent bank, are all on market terms. (Note: While the reporting requirements for lending from correspondent banks to insiders and from banks to the insiders of correspondent banks are no longer a requirement of Regulation O, the substantive restrictions remain a part of 12 USC 1972 (2).)

2. Disclosure is not required if the aggregate amount of all extensions of credit outstanding, including to related interests of such person, does not exceed $25,000.

OVERVIEW

The Fair and Accurate Credit Transactions Act of 2003 (FACT Act) was enacted on December 4, 2003.[1] The FACT Act added several provisions to the Fair Credit Reporting Act of 1970 (FCRA).[2] Section 114 of the FACT Act[3] amended section 615 of the FCRA, and directed the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Federal Trade Commission to issue joint regulations and guidelines regarding the detection, prevention, and mitigation of identity theft. Further, the agencies were directed to issue special regulations requiring debit and credit card issuers to validate notifications of changes of address under certain circumstances. In 2007, the agencies issued joint regulations and guidelines.[4] See section 222 of the Board's Regulation V—Fair Credit Reporting (12 CFR pt. 222).

The goal of the identity theft red flags rule (12 CFR pt. 222, Subpart J) and its Guidelines (12 CFR 222, Appendix J) is to ensure that financial institutions and creditors are alert for signs or indicators that an identity thief is misusing another individual's sensitive data, typically to obtain products or services from the institution or creditor. The identity theft red flags rule periodically requires a financial institution to determine whether it offers or maintains accounts covered by the regulation.[5] A covered account generally is a consumer account or any other account the institution determines carries a foreseeable risk of identity theft. For new or existing covered accounts, the regulation requires an institution to develop and implement a written Identity Theft Prevention Program (program) that is designed to detect, prevent, and mitigate identity theft. The program must be appropriate to the size and complexity of the financial institution and the nature and scope of its activities.

In general, safety-and-soundness examiners with experience in operational risk will review institutions for compliance with the identity theft red flags rule. This manual section explains certain financial institution safety-and-soundness provisions of the identity theft red flags rule and guidelines.

For additional information, see

- SR-08-7/CA-08-10, "Interagency Examination Procedures for the Identity Theft Red Flags and Other Regulations under the Fair Credit Reporting Act"
- Frequently Asked Questions on Identity Theft Rules (Jun. 11, 2009)
- The Board's Regulation V, "Fair Credit Reporting" (12 CFR pt. 222)

IDENTITY THEFT RED FLAGS PROGRAM

The term "account" is defined in the identify theft red flags rule as a continuing relationship established by a person with a financial institution or creditor to obtain a product or service for personal, family, household, or business purposes. The definition of "covered account" is divided into the following two parts:

(1) Accounts that a financial institution offers or maintains, primarily for personal, family, or household purposes, that involves or is designed to permit multiple payments or transactions; and
(2) Any other account that the financial institution offers or maintains for which there is a reasonably foreseeable risk to customers or to the safety and soundness of the financial institution from identity theft.

1. Pub. L. 108–159.
2. 15 U.S.C. 1681 et seq.
3. 15 U.S.C. 1681m(e).
4. 72 Fed. Reg. 63,718 (Nov. 9, 2007).
5. The term financial institution means a "financial institution or creditor" with regard to the red flags program joint regulations and the accompanying interagency guidance. The FCRA definition of "financial institution" applies to: (1) all banks, savings associations, and credit unions, regardless of whether they hold a transaction account belonging to a consumer; and (2) any other person that directly or indirectly holds a transaction account belonging to a consumer. Accordingly, all banks, savings associations, and credit unions are covered by the red flags rules and Guidelines as "financial institutions," whether or not they hold a transaction account belonging to a consumer. Further, banks and savings associations, including those whose powers are limited to trust activities, are covered by the red flags rules and Guidelines. See also the Frequently Asked Questions on Identity Theft Rules (Jun. 11, 2009).

Risk Assessment

As part of developing and maintaining an effective program, a financial institution must initially and then periodically conduct a risk assessment to determine whether it offers or maintains covered accounts. The program must take into consideration (1) the methods it provides to open its accounts, (2) the methods it provides to access accounts, and (3) its previous experiences with identity theft.

If the financial institution determines that it has covered accounts, the risk assessment will enable it to identify which of its accounts the program must address. If a financial institution initially determines that it does not have covered accounts, the identity theft red flag rule requires the institution to periodically reassess whether it must develop and implement a program in light of changes in the accounts that it offers or maintains.

Elements of the Identity Theft Prevention Program

The elements of an institution's program will vary depending on the size and complexity of the financial institution. A financial institution that determines that it is required to establish and maintain a program must

- identify relevant red flags for its covered accounts,[6]
- detect and respond to the red flags that have been incorporated into its program,
- respond appropriately to the detected red flags, and
- periodically update the program to address the changing risks from identity theft associated with its customers and their accounts and to the safety and soundness of the financial institution.

Administration of the Identity Theft Prevention Program

Each financial institution or creditor that is required to implement a program must provide for the continued administration of the program by

- obtaining approval of the initial written program from either its board of directors or an appropriate committee of the board of directors;
- involving the board of directors, an appropriate committee thereof, or a designated employee at the level of senior management in the oversight, development, implementation, and administration of the program;
- training staff, as necessary, to effectively implement the program; and
- exercising appropriate and effective oversight of service provider arrangements.

GUIDELINES (12 CFR PT. 222, APPENDIX J)

Each financial institution that is required to implement an Identity Theft Prevention Program must consider the Guidelines for Identity Theft Detection, Prevention, and Mitigation's in Appendix J (12 CFR pt. 222, Appendix J) and include those guidelines that are appropriate in its program. Section I of the guidelines, "The Program," discusses an Identity Theft Prevention Program's design that may include, as appropriate, existing policies, procedures, and arrangements that control foreseeable risks to the institution's customers or to the safety and soundness of the financial institution from identity theft.

Identification of Red Flags

A financial institution should include red flags into its program from sources such as (1) incidents of identity theft that it has experienced, (2) methods of identity theft that have been identified as reflecting changes in identity theft risks, and (3) applicable supervisory guidance.

Categories of Red Flags

The program should follow the approach regarding the identification of red flags in section II(c) of the guidelines, "Categories of Red Flags," which provides guidance in identifying relevant red flags. No specific red flags are mandatory for all financial institutions, but a financial institu-

6. The red flags are patterns, practices, or specific activities that indicate the possible existence of identity theft or the potential to lead to identity theft.

tion should include, as appropriate:[7]

- alerts, notifications, or other warnings received from consumer reporting agencies or service providers, such as fraud detection services;
- the presentation of suspicious documents and personal identifying information, such as a suspicious address change;
- the unusual use of, or other suspicious activity related to, a covered account; and
- a notice received from customers, victims of identity theft, law enforcement authorities, or other persons regarding possible identity theft in connection with covered accounts held by the financial institution.

The above categories do not represent a comprehensive list of all types of red flags that may indicate the possibility of identity theft. Institutions should also consider the types of covered accounts it offers and maintains, the methods it provides to open and access those accounts, and any previous exposures to identity theft.

Detect the Identity Theft Prevention Program's Red Flags

In accordance with section III of the guidelines, each financial institution's program should address the detection of red flags in connection with the opening of covered accounts and existing covered accounts. The policies and procedures regarding opening a covered account and existing covered accounts subject to the program should address the detection of red flags, such as by obtaining identifying information about, and verify the identity of, a person opening an account and, in the case of existing covered accounts, authenticating customers, monitoring transactions, and verifying the validity of change of address request.

Respond Appropriately to Any Detected Red Flags

Section IV of the guidelines, "Preventing and Mitigating Identity Theft," states that an institution's procedures should provide for appropriate responses to detected red flags that are commensurate with the degree of risk posed. When determining an appropriate response, the institution should consider factors that may heighten the institution's identity-theft risk. Such factors may include (1) a data security incident that results in unauthorized access to a customer's account records held by the financial institution, creditor, or third party, or (2) notice that a customer has provided information related to a covered account held by the financial institution or creditor to someone fraudulently claiming to represent the financial institution or creditor or to a fraudulent website.

Appropriate responses may include the following:

- monitoring a covered account for evidence of identity theft;
- contacting the customer;
- changing any passwords, security codes, or other security devices that permit access to a secured account;
- reopening a covered account with a new account number;
- closing an existing covered account;
- notifying law enforcement; or
- determining that no response is warranted under the particular circumstances.

Depending on the circumstances, refraining from making a response may be the most prudent course of action for the financial institution to prevent and mitigate identity theft. For example, the financial institution could elect to

- not open a new covered account; or
- not attempt to collect on a covered account or to sell a covered account to a debt collector.

Periodically Updating the Program's Relevant Red Flags

Section V of the guidelines, "Updating the Program," states that a financial institution should periodically update its program (including its relevant red flags) to reflect any changes in risks to its customers or to the safety and soundness of the institution from identity theft, based on (but not limited to) factors such as

7. Examples of red flags from each of these categories are appended as supplement A to appendix J.

- the experiences of the financial institution with identity theft;
- changes in methods of identity theft;
- changes in methods to detect, prevent, and mitigate identity theft;
- changes in the types of accounts that the financial institution offers or maintains; and
- changes in the financial institution's structure, including its mergers, acquisitions, joint ventures, and any business arrangements, such as alliances and service provider arrangements.

Administration of Program

Under the identity theft red flags rule, a financial institution that is required to implement a program must provide for the continued oversight and administration of its program. Section VI of the Guidelines, "Methods for Administering the Program," outlines steps to effectively administer the program.

The board of directors, an appropriate committee of the board, or a designated employee at the level of senior management should:

- assign specific responsibility for the program's implementation,
- review reports regarding the institution's compliance, and
- approve material changes to the program as necessary to address changing identity theft risks.

Financial institution staff responsible for developing, implementing, and administrating the program should report to the board of directors, an appropriate committee of the board, or a designated employee at the level of senior management at least annually. The report should address

- the effectiveness of the policies and procedures in addressing the risk of identity theft in connection with the opening of covered accounts and with respect to existing covered accounts;
- significant incidents involving identity theft and management's response;
- recommendations for material changes to the program; and
- service provider arrangements.

Whenever a financial institution engages a service provider to perform an activity in connection with one or more covered accounts, the institution should ensure that the activity of a service provider is conducted in accordance with reasonable policies and procedures designed to detect, prevent, and mitigate the risk of identity theft. For example, the financial institution could establish a contract with the service provider that specifies policies and procedures to detect relevant red flags that may arise in the performance of the service provider's activities, which should be mitigated and be reported to the financial institution or creditor.

SECTIONS 23A AND 23B OF THE FEDERAL RESERVE ACT AND REGULATION W

Section 23A of the Federal Reserve Act (FRA) (12 USC 371c) is the primary statute governing transactions between a member bank and its affiliates. Section 23A (1) designates the types of companies that are affiliates of a bank; (2) specifies the types of transactions covered by the statute; (3) sets the quantitative limitations on a bank's covered transactions with any single affiliate, and with all affiliates combined; (4) sets forth collateral requirements for certain bank transactions with affiliates; and (5) requires all covered transactions to be conducted on terms consistent with safe and sound banking practices.

In addition to the statutory provisions of section 23A, the Board approved the issuance of Regulation W, which became effective April 1, 2003, implementing sections 23A and 23B of the FRA. To facilitate compliance with these statutes, the rule[1] provides several exemptions and combines the statutory restrictions on transactions between a member bank and its affiliates with numerous Board interpretations and exemptions that were previously issued.

Quantitative Limits

Section 23A(a)(1)(A) states that a member bank[2] may engage in a covered transaction with an affiliate if the aggregate amount of covered transactions with that particular affiliate does not exceed 10 percent of the member bank's capital stock and surplus. Sections 223.11 and 223.12 of the rule sets forth these quantitative limits. A bank that has crossed the 10 percent threshold with one affiliate may still conduct additional covered transactions with other affiliates, if transactions with all affiliates would not exceed 20 percent of the bank's capital stock and surplus.[3] The bank is prohibited from engaging in a new covered transaction with that affiliate if the bank's transactions would exceed the 10 percent threshold with that affiliate or if the level of covered transactions with all its affiliates would exceed the 20 percent threshold. The rule generally does not require the member bank to unwind existing covered transactions if the bank exceeds the 10 percent or 20 percent limit because its capital declined or a preexisting covered transaction increased in value.

The Board strongly encourages member banks with covered transactions in excess of the 10 percent threshold with any affiliate to reduce those transactions before expanding the scope or extent of the bank's relationships with other affiliates.

Capital Stock and Surplus

Under section 23A of the FRA, the quantitative limits on covered transactions are based on the "capital stock and surplus" of the member bank. Section 223.3(d) of the rule defines a member bank's capital stock and surplus, for the purposes of section 23A of the FRA, as (1) the sum of the member bank's tier 1 capital and tier 2 capital under the risk-based capital guidelines, (2) the balance of the bank's allowance for loan and lease losses not included in its tier 2 capital for the purposes of the risk-based capital calculation, and (3) the amount of any investment in a financial subsidiary that counts as a covered transaction that is required to be deducted from the bank's regulatory capital.[4]

Examiners can determine the amount of the quantitative limits based on the bank's most recent Consolidated Report of Condition and Income (Call Report).

1. In this section of the manual, Regulation W is referred to as "the rule" or by a specific section number of the rule.
2. Member bank is defined in section 223.3(w) as "any national bank, state bank, banking association, or trust company that is a member of the Federal Reserve System." Other provisions of federal law apply section 23A to state nonmember banks and savings associations. The rule also states that most subsidiaries of a member bank are to be treated as part of the member bank itself for purposes of sections 23A and 23B. The only subsidiaries of a member bank that are excluded from this treatment are financial subsidiaries, insured depository institution subsidiaries, and certain joint venture subsidiaries—companies that are generally deemed affiliates of the member bank under the rule. This treatment of subsidiaries reflects the fact that the statute typically does not distinguish between a member bank and its subsidiaries, and all the significant restrictions of the statute apply to actions taken by a member bank "and its subsidiaries."
3. See 12 USC 371c(a)(1). Sections 223.11 and 223.12 of the rule set forth these quantitative limits.
4. 12 CFR 223.3(d).

Affiliates

The definition of an affiliate is found in section 23A(b) of the FRA. Section 223.2 of Regulation W further defines "affiliate" as including

1. any company that controls[5] the member bank and any other company that is controlled by the company that controls the member bank;
2. any bank subsidiary of the member bank;
3. any company—
   - that is controlled directly or indirectly, by a trust or otherwise, by or for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, by trust or otherwise, the member bank or any company that controls the member bank; or
   - in which a majority of its directors or trustees constitute a majority of the persons holding any such office with the member bank or any company that controls the member bank;
4. any company, including a real estate investment trust, that is sponsored and advised on a contractual basis by the member bank or any subsidiary or affiliate of the member bank;
5. any investment company with respect to which a member bank or any affiliate thereof is an investment adviser as defined in section 2(a)(20) of the Investment Company Act of 1940 (the 1940 Act);
6. any investment fund for which the member bank or any affiliate of the member bank serves as an investment adviser, if the member bank and its affiliates own or control in the aggregate more than 5 percent of any class of voting securities or of the equity capital of the fund (any investment fund or company with respect to which a member bank or affiliate thereof is an investment adviser; see section 608(a)(l)(A) of the Dodd-Frank Act);
7. a depository institution that is a subsidiary of the member bank;
8. a financial subsidiary of the member bank;
9. any company in which a holding company of the member bank owns or controls, directly or indirectly, or acting through one or more other persons, 15 percent or more of the equity capital of the other company[6] pursuant to the merchant banking authority in section 4(k)(4)(H) or (I) of the Bank Holding Company Act (BHC Act) (12 USC 1843(k)(4)(H) or (I));
10. any partnership for which the member bank or any affiliate of the member bank serves as a general partner or for which the member bank or any affiliate of the member bank causes any director, officer, or employee of the member bank or affiliate to serve as a general partner;
11. any subsidiary of an affiliate described in paragraphs (a)(1) through (10) of section 223.2 of Regulation W; and
12. any company that the Board, or the appropriate federal banking agency for the bank, determines by regulation or order to have a relationship with the member bank or any subsidiary or affiliate of the member bank, such that covered transactions by the member bank or its subsidiary with that company may be affected by the relationship, to the detriment of the member bank or its subsidiary.

The following are not considered to be affiliates to a bank:

1. a nonbank subsidiary of that bank (other than a financial subsidiary) unless the Board determines not to exclude such a subsidiary;
2. a company engaged solely in holding that bank's premises;
3. a company engaged solely in conducting a safe deposit business;
4. a company engaged solely in holding obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest; and
5. a company in which control arises from the exercise of rights arising out of a bona fide debt previously contracted (for the period of time specified by section 23A).

5. By statute, "control" is defined as the power to (1) vote 25 percent or more of the voting shares of a company, (2) elect a majority of the directors of a company, or (3) exercise a controlling influence over a company.

6. The financial holding company may provide information acceptable to the Board demonstrating that it does not control the other company.

Definition of Affiliates by Type of Entity

Investment funds advised by the member bank or an affiliate of the member bank. Regulation W includes as an affiliate any company that is sponsored and advised on a contractual basis by the member bank or any of its affiliates,[7] as well as any investment company for which the member bank or its affiliate serves as an investment adviser, as defined in the 1940 Act.[8] In Regulation W, the Board used its statutory authority to define as an affiliate any investment fund—even if not an investment company for purposes of the 1940 Act—for which the member bank or an affiliate of the bank serves as an investment adviser, if the bank or an affiliate of the bank owns or controls more than 5 percent of any class of voting securities or similar interests of the fund.

Many investment funds that are advised by a member bank (or an affiliate of a member bank) are affiliates of the bank under section 23A because the funds either are investment companies under the 1940 Act or are sponsored by the member bank (or an affiliate of the member bank). The member bank or its affiliate, in some instances, however, may advise but not sponsor an investment fund that is not an investment company under the 1940 Act.[9] The advisory relationship of a member bank or affiliate with an investment fund presents the same potential for conflicts of interest regardless of whether the fund is an investment company under the 1940 Act.[10] The Dodd-Frank Act treats any investment fund as an affiliate if the bank or an affiliate of the bank serves as an investment adviser to the fund.

Financial Subsidiaries. In 1999, the Gramm-Leach-Bliley Act (the GLB Act) authorized banks to own "financial subsidiaries" that engage in activities not permissible for the parent bank to conduct directly, such as underwriting and dealing in bank-ineligible securities. The GLB Act amended section 23A to define a financial subsidiary of a bank as an affiliate of the bank and thus subjected covered transactions between the bank and a financial subsidiary to the limitations of sections 23A and 23B.

Section 23A defines a financial subsidiary as a subsidiary of any bank (state or national) that is engaged in an activity that is not permissible for national banks to engage in directly other than a subsidiary that federal law specifically authorizes national banks to own or control. Specifically, a "financial subsidiary" is defined as "any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United States."[11] Section 5136A, in turn, defines a financial subsidiary as any company that is controlled by one or more insured depository institutions (IDIs), other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly or (2) a subsidiary that national banks are specifically authorized to control by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or a small business investment company (SBIC).[12] (See 12 USC 24a(g)(3).) Section 5136A also generally prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[13] (See 12 USC 24a(a)(2)). Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.2(a)(8), 223.3(p), and 223.32 of the rule.)

Partnerships. Banks fund legitimate commercial transactions through partnerships. Partnerships for which a member bank or an affiliate serves as a general partner are affiliates.

Regulation W also defines an affiliate of a member bank as any partnership, if the member bank or an affiliate of the bank causes any director, officer, or employee of the bank or affiliate to serve as a general partner of the partnership (unless the partnership is an operating subsidiary of the bank). Also, if a company,

7. 12 USC 371c(b)(1)(D)(i).
8. 12 USC 371c(b)(1)(D)(ii).
9. 12 USC 371c(b)(1)(E).
10. An investment fund typically escapes from the definition of investment company under the 1940 Act because it (1) sells interests only to a limited number of investors or only to sophisticated investors or (2) invests primarily in financial instruments that are not securities. A member bank may face greater risk from the conflicts of interest arising from its relationships with an investment fund that is not registered than an investment company under the 1940 Act because the 1940 Act restricts transactions between a registered investment company and entities affiliated with the company's investment adviser. (See 15 USC 80a-17.)

11. 12 USC 24a(g)(3). (See also 12 USC 371c(e)(1)).
12. 12 USC 24a(a)(2).
13. 12 USC 371c(e)(1).

such as a bank holding company (BHC), controls more than 25 percent of the equity through a partnership, that company is an affiliate under Regulation W.

Subsidiaries of affiliates. Regulation W deems a subsidiary of an affiliate as an affiliate of the member bank.

Companies Designated by the Appropriate Federal Banking Agency

Under section 223.2(a)(12), the Board can determine that any company that has certain relationships with a member bank or an affiliate of the bank is itself an affiliate of the bank such that covered transactions by the bank with that company may be affected by the relationship to the detriment of the bank. The Board and the federal banking agencies can thus protect the member bank in their transactions with associated companies. A member bank may petition the Board for review of any such affiliate determination made by the institution's appropriate federal banking agency under the general procedures established by the Board for review of actions taken under delegated authority.[14]

Companies That Are Not Affiliates

Joint venture companies. Under section 223.2(b)(1)(iii) of the rule, certain joint venture subsidiary companies of a member bank are treated as affiliates. A subsidiary of a member bank is treated as an affiliate if one or more affiliates of the bank, or one or more controlling shareholders of the bank, directly control the joint venture. For example, if a bank controls 30 percent of Company A and an affiliate controls 70 percent of Company A, then Company A is an affiliate. This provision also covers situations in which a controlling natural-person shareholder or group of controlling natural-person shareholders of the member bank (who, as natural persons, are not themselves section 23A affiliates of the bank) exercise direct control over the joint venture company.

The rule's treatment of certain bank-affiliate joint ventures as affiliates does not apply to joint ventures between a member bank and any affiliated IDIs. For example, if two affiliated member banks each own 50 percent of the voting common shares of a company, the company would continue to qualify as a subsidiary and not an affiliate of each bank (despite the fact that an affiliate of each bank owned more than 25 percent of a class of voting securities of the company). The Board has retained its authority to treat such joint ventures as affiliates under section 23A on a case-by-case basis.

Employee benefit plans. Regulation W clarifies that under section 223.2(b)(1)(iv), an employee stock option plan (ESOP) of a member bank or an affiliate of the bank cannot itself avoid classification as an affiliate of the bank by also qualifying as a subsidiary of the bank. Many, but not all, ESOPs, trusts, or similar entities that exist to benefit shareholders, members, officers, directors, or employees of a member bank or its affiliates are treated as affiliates of the bank for purposes of sections 23A and 23B. The ESOP's share ownership or the interlocking management between the ESOP and its associated member bank (or BHC), in many cases, exceeds the statutory thresholds for determining that a company is an affiliate. For example, if an ESOP controls more than 25 percent of the voting shares of the bank or BHC, the ESOP is an affiliate.

The relationship between a member bank and its (or its) affiliate's ESOP generally warrants coverage by sections 23A and 23B. Member banks have made unsecured loans to their ESOPs or their affiliates or have guaranteed loans to such ESOPs that were made by a third party. These ESOPs, however, generally have no means to repay the loans other than with funds provided by the member bank. In addition, even if the ESOP's ownership does not warrant treatment as an affiliate, the issuance of holding company shares to an ESOP that is funded by a loan from the holding company's subsidiary bank could be used as a vehicle by the bank to provide funds to its parent company when the bank is unable to pay dividends or is otherwise restricted in providing funds to its holding company. The attribution rule (12 CFR 223.16) subjects such transactions to the restrictions of sections 23A and 23B.

14. See 12 CFR 265.3.

Determination of Control

Section 23A provides that a company or shareholder shall be deemed to have control over another company if, among other things, such company or shareholder controls in any manner the election of a majority of the "directors or trustees" of the other company.[15] The rule, under section 223.3(g), expands the control definition of section 23A by providing, as in Regulation Y, that control also exists when a company or shareholder controls the election of a majority of the "general partners (or individuals exercising similar functions)" of another company. A company or shareholder would be deemed to control another company (including a partnership, limited-liability company, or other similar organization) under section 23A if the company or shareholder controls the election of a majority of the principal policymakers of such other company.

Under Regulation W, the definition of "control" is similar, but not identical, to the definition used in the BHC Act. Under the rule, a company or shareholder shall be deemed to have control over another company if—

- such company or shareholder, directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the other company;
- such company or shareholder controls in any manner the election of a majority of the directors or trustees or general partners or individuals exercising similar functions of the other company; or
- the Board determines, after notice and opportunity for hearing, that such company or shareholder, directly or indirectly, exercises a controlling influence over the management or policies of the other company.[16]

In addition, under the rule, three additional presumptions of control are provided, similar to the presumptions of control in Regulation Y. First, a company will be deemed to control securities, assets, or other ownership interests controlled by any subsidiary of the company.[17] Second, a company that controls instruments (including options and warrants) that are convertible or exercisable, at the option of the holder or owner, into securities, will be deemed to control the securities.[18] Third, a rebuttable presumption provides that a company or shareholder that owns or controls 25 percent or more of the equity capital of another company controls the other company, unless the company or shareholder demonstrates otherwise to the Board based on the facts and circumstances of the particular case.[19] (See section 223.3(g).) Such a presumption of control is particularly appropriate in the section 23A context because a BHC may have incentives to divest the resources of a subsidiary bank to any company in which the holding company has a substantial financial interest, regardless of whether the holding company owns any voting securities of the company.

Section 23A and Regulation W provide that no company shall be deemed to own or control another company by virtue of its ownership or control of shares in a fiduciary capacity, except (1) a company that is controlled, directly or indirectly, by a trust for the benefit of shareholders who beneficially or otherwise control, directly or indirectly, a member bank or (2) if the company owning or controlling such shares is a business trust.

Covered Transactions

The restrictions of section 23A do not apply to every transaction between a member bank and its affiliates.[20] The section only applies to seven "covered transactions" between a member bank and its affiliates.

A covered transaction under section 23A means

1. a loan or extension of credit to an affiliate, including a purchase of assets subject to an agreement to repurchase;
2. a purchase of or an investment in securities issued by an affiliate;
3. a member bank's purchase of assets from an

15. 12 USC 371c(b)(3)(A)(ii).
16. See 12 CFR 223.3(g) of the rule.
17. See 12 CFR 225.2(e)(2)(i).
18. See 12 CFR 225.31(d)(1)(i). The rule refers more generically to convertible "instruments." It clarifies that the convertibility presumption applies regardless of whether the right to convert resides in a financial instrument that technically qualifies as a "security" under section 23A or the federal securities laws.
19. See, for example, 12 CFR 225.144 and 225.145 (1982 and 2008 Board Policy Statements on Nonvoting Equity Investments).
20. 12 USC 371c(b)(7).

affiliate, except for purchases of real and personal property as may be specifically exempted by the Board by order or regulation;
4. the acceptance of securities or other debt obligations issued by an affiliate as collateral for a loan to any person or company;[21] or
5. the issuance of a guarantee, acceptance, or letter of credit, including an endorsement or standby letter of credit, on behalf of an affiliate.
6. a transaction with an affiliate that involves the borrowing or lending of securities to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or
7. a derivative transaction, as defined in 12 USC 84(b) with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate.

If a transaction between a member bank and an affiliate is not within one of the above categories, it is not a covered transaction for the purposes of section 23A and is not subject to its limitations. All covered transactions must be conducted on terms and conditions that are consistent with safe and sound banking practices.[22]

Among the transactions that generally are not subject to section 23A are dividends paid by a member bank to its holding company, sales of assets by a member bank to an affiliate for cash, an affiliate's purchase of securities issued by a member bank, and many service contracts between a member bank and an affiliate. Certain classes of transactions between a member bank and an affiliate are discussed below as to whether they are covered transactions for purposes of section 23A. (See section 223.3(h).)

Attribution Rule

The "attribution rule," found in section 223.16, provides that any covered transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. For example, a member bank's loan to a customer for the purpose of purchasing securities from the inventory of a broker–dealer affiliate of the bank would be a covered transaction under section 23A.

Credit Transactions with an Affiliate

Extension of Credit to an Affiliate or Other Credit Transaction with an Affiliate

Section 23A includes a "loan or extension of credit" to an affiliate as a covered transaction but does not define these terms. Section 223.3(o) of the rule defines "extension of credit" to an affiliate to mean the making or renewal of a loan to an affiliate, the granting of a line of credit to an affiliate, or the extending of credit to an affiliate in any manner whatsoever, including on an intraday basis. A list of transactions are defined to be extensions of credit in the rule, but are not limited to the following transactions:

1. an advance to an affiliate by means of an overdraft, cash item, or otherwise
2. a sale of federal funds to an affiliate
3. a lease that is the functional equivalent of an extension of credit to an affiliate
4. an acquisition by purchase, discount, exchange, or otherwise of a note or other obligation, including commercial paper or other debt securities, of an affiliate[23]
5. any increase in the amount of, extension of the maturity of, or adjustment to the interest-rate term or other material term of, an extension of credit to an affiliate[24]

21. The acceptance of an affiliate's securities for a loan where the proceeds are transferred to, or used for the benefit of, an affiliate is prohibited.

22. Board staff has taken the position that safety and soundness requires the transaction be conducted on market terms.

23. The Board would consider a full-payout net lease permissible for a national bank under 12 USC 24 (seventh) and 12 CFR 23 to be the functional equivalent of an extension of credit.

24. A floating-rate loan does not become a new covered transaction whenever there is a change in the relevant index (for example, LIBOR or the member bank's prime rate) from which the loan's interest rate is calculated. If the member bank and the borrower, however, amend the loan agreement to change the interest-rate term from "LIBOR plus 100 basis points" to "LIBOR plus 150 basis points," the parties have engaged in a new covered transaction.

6. any other similar transaction as a result of which an affiliate becomes obligated to pay money (or its equivalent) to a member bank[25]

A member bank's purchase of a debt security issued by an affiliate is an extension of credit by the bank to the affiliate for purposes of section 23A under the rule. A member bank that buys debt securities issued by an affiliate has made an extension of credit to an affiliate under section 23A and must collateralize the transaction in accordance with the collateral requirements of section 23A. An exemption from the collateral requirements is provided for situations in which a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction.

Issuance of a Guarantee or Letter of Credit

Confirmation of a Letter of Credit Issued by an Affiliate

Section 23A includes as a covered transaction the issuance by a member bank of a letter of credit on behalf of an affiliate, including the confirmation of a letter of credit issued by an affiliate as a covered transaction. See section 223.3(h)(5).[26] When a bank confirms a letter of credit, it assumes the risk of the underlying transaction to the same extent as if it had issued the letter of credit. Accordingly, a confirmation of a letter of credit issued by an affiliate is treated in the same fashion as an issuance of a letter of credit on behalf of an affiliate.

Credit Enhancements Supporting a Securities Underwriting

The definition of guarantee in section 23A does not include a member bank's issuance of a guarantee in support of securities issued by a third party and underwritten by a securities affiliate of the bank.[27] Such a credit enhancement would not be issued "on behalf of" the affiliate. Although the guarantee does provide some benefit to the affiliate (by facilitating the underwriting), this benefit is indirect. The proceeds of the guarantee would not be transferred to the affiliate for purposes of the attribution rule of section 23A.[28] Section 23B would apply to the transaction and, where an affiliate was issuer as well as underwriter, the transaction would be covered by section 23A because the credit enhancement would be on behalf of the affiliate.

Cross-Guarantee Agreements and Cross-Affiliate Netting Arrangements

A cross-guarantee agreement among a member bank, an affiliate, and a nonaffiliate in which the nonaffiliate may use the bank's assets to satisfy the obligations of a defaulting affiliate is a guarantee for purposes of section 23A. The cross-guarantee arrangements among member banks and their affiliates are subject to the quantitative limits and collateral requirements of section 23A. (See section 223.3(h)(5).)

As for cross-affiliate netting arrangements (CANAs), such arrangements involve a member bank, one or more affiliates of the bank, and one or more nonaffiliates of the bank, where a nonaffiliate is permitted to deduct obligations of an affiliate of the bank to the nonaffiliate when settling the nonaffiliate's obligations to the bank. These arrangements also would include agreements in which a member bank is required or permitted to add the obligations of an affiliate of the bank to a nonaffiliate when determining the bank's obligations to the nonaffiliate.

These types of CANAs expose a member bank to the credit risk of its affiliates because the bank may become liable for the obligations of its affiliates. Because the exposure of a member bank to an affiliate in such an arrangement resembles closely the exposure of a member bank when it issues a guarantee on behalf of an affiliate, the rule explicitly includes such arrangements in the definition of covered transaction. Accordingly, the quantitative limits of section 23A would prohibit a member bank from entering into such a CANA to the extent that the netting arrangement does not cap the potential exposure of the bank to the participating affiliate (or affiliates).

25. The definition of extension of credit would cover, among other things, situations in which an affiliate fails to pay on a timely basis for services rendered to the affiliate by the member bank or fails to pay a tax refund to the member bank.

26. See UCC 5-107(2).

27. See 62 *Fed. Reg.* 45295 (August 27, 1997).

28. See 12 USC 371c(a)(2).

Keepwell Agreements

In a keepwell agreement between a member bank and an affiliate, the bank typically commits to maintain the capital levels or solvency of the affiliate. The credit risk incurred by the member bank in entering into such a keepwell agreement is similar to the credit risk incurred by a member bank in connection with issuing a guarantee on behalf of an affiliate. As a consequence, keepwell agreements generally should be treated as guarantees for purposes of section 23A and, if unlimited in amount, would be prohibited by the quantitative limits of section 23A.

Valuation of Credit Transactions with an Affiliate

A credit transaction between a member bank and an affiliate initially must be valued at the amount of funds provided by the member bank to, or on behalf of, the affiliate plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate. The section 23A value of a credit transaction between a member bank and an affiliate is the greater of (1) the principal amount of the credit transaction; (2) the amount owed by the affiliate to the member bank under the credit transaction; or (3) the sum of (a) the amount provided to, or on behalf of, the affiliate in the transaction and (b) any additional amount that the member bank could be required to provide to, or on behalf of, the affiliate under the terms of the transaction.

The first prong of the rule's valuation formula for credit transactions ("the principal amount of the credit transaction") would likely determine the valuation of a transaction in which a member bank purchased a zero-coupon note issued by an affiliate. A member bank should value such an extension of credit at the principal, or face, amount of the note (that is, at the amount that the affiliate ultimately must pay to the bank) rather than at the amount of funds initially advanced by the bank. For example, assume a member bank purchased from an affiliate for $50 a 10-year zero-coupon note issued by the affiliate with a face amount of $100. The rule's valuation formula requires the member bank to value this transaction at $100.

The second prong of the rule's valuation formula for credit transactions ("the amount owed by the affiliate") likely would determine the valuation of a transaction in which an affiliate fails to pay a member bank when due a fee for services rendered by the bank to the affiliate. This prong of the valuation formula does not include within section 23A's quantitative limits items such as accrued interest not yet due on a member bank's loan to an affiliate.

Member banks will be able to determine the section 23A value for most credit transactions under the third prong of the rule's valuation formula. Under this prong, for example, a $100 term loan is a $100 covered transaction, a $300 revolving credit facility is a $300 covered transaction (regardless of how much of the facility the affiliate has drawn down), and a guarantee backstopping a $500 debt issuance of the affiliate is a $500 covered transaction.

Under section 23A and the rule, a member bank has made an extension of credit to an affiliate if the bank purchases from a third party a loan previously made to an affiliate of the bank. A different valuation formula is provided for these indirect credit transactions. The member bank must value the transaction at the price paid by the bank for the loan plus any additional amount that the bank could be required to provide to, or on behalf of, the affiliate under the terms of the credit agreement.

For example, if a member bank pays a third party $90 for a $100 term loan that the third party previously made to an affiliate of the bank (because, for example, the loan was at a fixed rate and has declined in value because of a rise in the general level of interest rates), the covered transaction amount is $90 rather than $100. The lower covered-transaction amount reflects the fact that the member bank's maximum loss on the transaction is $90 rather than the original principal amount of the loan. For another example, if a member bank pays a third party $70 for a $100 line of credit to an affiliate, of which $70 had been drawn down by the affiliate, the covered-transaction amount would be $100 (the $70 purchase price paid by the bank for the credit plus the remaining $30 that the bank could be required to lend under the credit line).

In another example, a member bank makes a term loan to an affiliate that has a principal amount of $100. The affiliate pays $2 in up-front fees to the member bank, and the affiliate receives net loan proceeds of $98. The member bank must initially value the covered transaction at $100.

Although the rule considers a member bank's purchase of, or investment in, a debt security issued by an affiliate as an extension of credit to an affiliate, these transactions are not valued like other extensions of credit. See section 223.23 for the valuation rules for purchases of, and investments in, the debt securities of an affiliate.

Timing of a Credit Transaction with an Affiliate

A member bank has entered into a credit transaction with an affiliate at the time during the day that the bank becomes legally obligated to make the extension of credit to, or issue the guarantee, acceptance, or letter of credit on behalf of, the affiliate. A covered transaction occurs at the moment that the member bank executes a legally valid, binding, and enforceable credit agreement or guarantee and does not occur only when a member bank funds a credit facility or makes payment on a guarantee. Consistent with section 23A, the rule only requires a member bank to compute compliance with its quantitative limits when the bank is about to engage in a new covered transaction. The rule does not require a member bank to compute compliance with the rule's quantitative limits on a continuous basis. See section 223.21(b)(1) of the rule.

The burden of the timing rule is significantly mitigated by the exemption for intraday extensions of credit found in section 223.42(l). The intraday credit exemption generally applies only to extensions of credit that a member bank expects to be repaid, sold, or terminated by the end of its U.S. business day. The bank must have policies and procedures to manage and minimize the credit exposure. Any such extension of credit that is outstanding at the end of the bank's business day must be treated as an extension of credit and must meet the regulatory quantitative and collateral requirements.

Asset Purchases from an Affiliate

Regulation W provides that a purchase of assets by a member bank from an affiliate initially must be valued at the total amount of consideration given by the bank in exchange for the asset. (See section 223.22.) This consideration can take any form and includes an assumption of liabilities by the member bank. Asset purchases are a covered transaction for a member bank for as long as the bank holds the asset. The value of the covered transaction after the purchase may be reduced to reflect amortization or depreciation of the asset, to the extent that such reductions are consistent with generally accepted accounting principles (GAAP) and are reflected on the bank's financial statements.

Certain asset purchases by a member bank from an affiliate are not valued in accordance with the general asset-purchase valuation formula. First, if the member bank buys from one affiliate a loan to a second affiliate, the bank must value the transaction as a credit transaction with the second affiliate under section 223.21. Second, if the member bank buys from one affiliate a security issued by a second affiliate, the bank must value the transaction as an investment in securities issued by the second affiliate under section 223.23. Third, if the member bank acquires an affiliate that becomes an operating subsidiary of the bank after the acquisition, the bank must value the transaction under section 223.31.

A special valuation rule applies to a member bank's purchase of a line of credit or loan commitment from an affiliate. A member bank initially must value such asset purchases at the purchase price paid by the bank for the asset plus any additional amounts that the bank is obligated to provide under the credit facility.[29] This special valuation rule ensures that there are limits on the amount of risk a company can shift to an affiliated bank.

Section 23A(d)(6) provides an exemption for purchasing assets having a readily identifiable and publically available market quotation. Section 223.42(e) codifies this exemption. Section 223.42(f) of the rule expands the statutory (d)(6) exemption[30] to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, (1) the selling affiliate is a broker–dealer registered with the Securities and Exchange Commission (SEC), (2) the securities have a ready market and are eligible for purchase by state member banks, (3) the securities are not purchased within 30 days of an underwriting (if an affiliate of the

29. A member bank would not be required to include unfunded, but committed, amounts in the value of the covered transaction if (1) the credit facility being transferred from the affiliate to the bank is unconditionally cancelable (without cause) at any time by the bank and (2) the bank makes a separate credit decision before each drawing under the facility.

30. 12 USC 371c(d)(6).

bank is an underwriter of the securities), and (4) the securities are not issued by an affiliate.

In contrast with credit transactions, an asset purchase from a nonaffiliate that later becomes an affiliate generally does not become a covered transaction for the purchasing member bank. If a member bank purchases assets from a nonaffiliate in contemplation of the nonaffiliate's becoming an affiliate of the bank, however, the asset purchase becomes a covered transaction at the time the nonaffiliate becomes an affiliate. In addition, the member bank must ensure that the aggregate amount of the bank's covered transactions (including any such asset purchase from the nonaffiliate) would not exceed the quantitative limits of section 23A at the time the nonaffiliate becomes an affiliate.

The following examples are provided to assist member banks in valuing purchases of assets from an affiliate. A member bank's receipt of an encumbered asset from an affiliate ceases to be a covered transaction when, for example, the bank sells the asset.

- *Cash purchase of assets.* A member bank purchases a pool of loans from an affiliate for $10 million. The member bank initially must value the covered transaction at $10 million. Going forward, if the borrowers repay $6 million of the principal amount of the loans, the member bank may value the covered transaction at $4 million.
- *Purchase of assets through an assumption of liabilities.* An affiliate of a member bank contributes real property with a fair market value of $200,000 to the member bank. The member bank pays the affiliate no cash for the property, but assumes a $50,000 mortgage on the property. The member bank has engaged in a covered transaction with the affiliate and initially must value the transaction at $50,000. Going forward, if the member bank retains the real property but pays off the mortgage, the member bank must continue to value the covered transaction at $50,000. If the member bank, however, sells the real property, the transaction ceases to be a covered transaction at the time of the sale (regardless of the status of the mortgage).

Purchase of, and Investment in, Securities Issued by an Affiliate

Section 23A includes as a covered transaction a member bank's purchase of, or investment in, securities issued by an affiliate. Section 223.23 of the rule requires a member bank to value a purchase of, or investment in, securities issued by an affiliate (other than a financial subsidiary of the bank) at the greater of the bank's purchase price or carrying value of the securities.[31] A member bank that paid no consideration in exchange for affiliate securities has to value the covered transaction at no less than the bank's carrying value of the securities. In addition, if the member bank's carrying value of the affiliate securities increased or decreased after the bank's initial investment (due to profits or losses at the affiliate), the amount of the bank's covered transaction would increase or decrease to reflect the bank's changing financial exposure to the affiliate. However, the amount of the bank's covered transaction cannot decline below the amount paid by the bank for the securities.

Several important considerations support the general carrying-value approach of this valuation rule. First, the approach is consistent with GAAP, which would require a bank to reflect its investment in securities issued by an affiliate at carrying value throughout the life of the investment, even if the bank paid no consideration for the securities.

Second, the approach is supported by the terms of the statute, which defines both a "purchase of," and an "investment in," securities issued by an affiliate as a covered transaction. The statute's "investment in" language indicates that Congress was concerned with a member bank's continuing exposure to an affiliate through an ongoing investment in the affiliate's securities.

Finally, the carrying-value approach is consistent with the purposes of section 23A—limiting the financial exposure of banks to their affiliates and promoting safety and soundness. The valuation rule requires a member bank to revalue upwards the amount of an investment in affiliate securities only when the bank's exposure to the affiliate increases (as reflected on the bank's financial statements) and the bank's capital increases to reflect the higher value of the

31. Carrying value refers to the amount at which the securities are carried on the GAAP financial statements of the member bank.

investment. In these circumstances, the valuation rule merely reflects the member bank's greater financial exposure to the affiliate and enhances safety and soundness by reducing the bank's ability to engage in additional transactions with an affiliate as the bank's exposure to that affiliate increases.

The valuation rule also provides that the covered-transaction amount of a member bank's investment in affiliate securities can be no less than the purchase price paid by the bank for the securities, even if the carrying value of the securities declines below the purchase price. Although this aspect of the valuation rule is not consistent with GAAP, using the member bank's purchase price for the securities as a floor for valuing the covered transaction is appropriate. First, it ensures that the amount of the covered transaction never falls below the amount of funds actually transferred by the member bank to the affiliate in connection with the investment. In addition, the purchase-price floor limits the ability of a member bank to provide additional funding to an affiliate as the affiliate approaches insolvency. If investments in securities issued by an affiliate were valued strictly at carrying value, then the member bank could lend more funds to the affiliate as the affiliate's financial condition worsened. As the affiliate declined, the member bank's carrying value of the affiliate's securities would decline, the section 23A value of the bank's investment likely would decline, and, consequently, the bank would be able to provide additional funding to the affiliate under section 23A. This type of increasing support for an affiliate in distress is what section 23A was intended to restrict.

The examples provided below are designed to assist member banks in valuing purchases of, and investments in, securities issued by an affiliate.

- *Purchase of the debt securities of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company. The member bank purchases debt securities issued by the mortgage company for $600. The initial carrying value of the securities is $600. The member bank initially must value the investment at $600.
- *Purchase of the shares of an affiliate.* The parent holding company of a member bank owns 51 percent of the shares of a mortgage company. The member bank purchases an additional 30 percent of the shares of the mortgage company from a third party for $100. The initial carrying value of the shares is $100. The member bank initially must value the investment at $100. Going forward, if the member bank's carrying value of the shares declines to $40, the member bank must continue to value the investment at $100.
- *Contribution of the shares of an affiliate.* The parent holding company of a member bank owns 100 percent of the shares of a mortgage company and contributes 30 percent of the shares to the member bank. The member bank gives no consideration in exchange for the shares. If the initial carrying value of the shares is $300, then the member bank initially must value the investment at $300. Going forward, if the member bank's carrying value of the shares increases to $500, the member bank must value the investment at $500.

Extensions of Credit Secured by Affiliates' Securities

Extensions of Credit—General Valuation Rule (Section 223.24(a) and (b))

Section 23A defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company. This type of covered transaction has two classes: one in which the only collateral for the loan is solely affiliate securities and another in which the loan is secured by a combination of affiliate securities and other collateral.[32]

Extensions of Credit Secured by Mutual Fund Shares

Section 23A(b)(7)(D) of the FRA defines as a covered transaction a member bank's acceptance of securities issued by an affiliate as collateral security for a loan or extension of credit to any person or company.[33]

32. The securities issued by an affiliate cannot be used as collateral for a loan to any affiliate (12 USC 371c (c)(4).

33. See 12 USC 371c(b)(7)(D). This covered transaction only arises when the member bank's loan is to a nonaffiliate. Under section 23A, the securities issued by an affiliate are not acceptable collateral for a loan or extension of credit to any affiliate. See 12 USC 371c(c)(4). If the proceeds of a loan that is secured by an affiliate's securities are transferred to an

Section 223.24(c) of the rule provides an exemption for extensions of credit by a member bank that are secured by shares of an affiliated mutual fund. To qualify for the exemption, the transaction must meet several conditions. First, to ensure that the affiliate collateral is liquid and trades at a fair price, the affiliated mutual fund must be an open-end investment company that is registered with the SEC under the 1940 Act. Second, to ensure that the member bank can easily establish and monitor the value of the affiliate collateral, the affiliated mutual fund's shares serving as collateral for the extension of credit must have a publicly available market price. Third, to reduce the member bank's incentives to use these extensions of credit as a mechanism to support the affiliated mutual fund, the member bank and its affiliates must not own more than 5 percent of the fund's shares (excluding certain shares held in a fiduciary capacity). Finally, the proceeds of the extension of credit must not be used to purchase the affiliated mutual fund's shares serving as collateral or otherwise used to benefit an affiliate. In such circumstances, the member bank's extension of credit would be covered by section 23A's attribution rule. For example, a member bank proposes to lend $100 to a nonaffiliate secured exclusively by eligible affiliated mutual fund securities. The member bank knows that the nonaffiliate intends to use all the loan proceeds to purchase the eligible affiliated mutual fund securities that would serve as collateral for the loan. Under the attribution rule in section 223.16, the member bank must treat the loan to the nonaffiliate as a loan to an affiliate, and because securities issued by an affiliate are ineligible collateral under section 223.14, the loan would not be in compliance with section 223.14.

Under the rule, if the credit extension is secured exclusively by affiliate securities, then the transaction is valued at the full amount of the extension of credit. This approach reflects the difficulty of measuring the actual value of typically untraded and illiquid affiliate securities and conservatively assumes that the value of the securities is equal to the full value of the loan that the securities collateralize. An exception is provided to the general rule when the affiliate securities held as collateral have a ready market (as defined by section 223.42 of the rule). In that case, the transaction may be valued at the fair market value of the affiliate securities. The exception grants relief in those circumstances when the value of the affiliate securities is independently verifiable by reference to transactions occurring in a liquid market.[34]

Covered transactions of the second type, in which the credit extension is secured by affiliate securities and other collateral, are valued at the lesser of (1) the total value of the extension of credit minus the fair market value of the other collateral or (2) the fair market value of the affiliate securities (if the securities have a ready market). The rule's ready-market requirement applies regardless of the amount of affiliate collateral.[35]

A Member Bank's Acquisition of an Affiliate That Becomes an Operating Subsidiary

Section 223.31 (a)–(c) of the rule provides guidance to a member bank that acquires an affiliate. The first situation is when a member bank directly purchases or otherwise acquires the affiliate's assets and assumes the affiliate's liabilities. In this case, the transaction is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any separate consideration paid by the member bank for the affiliate's assets (if any), plus the amount of any liabilities assumed by the bank in the transaction.

The rule provides that the acquisition by a member bank of a company that was an affiliate of the bank before the acquisition is treated as a purchase of assets from an affiliate if (1) as a result of the transaction, the company becomes an operating subsidiary of the bank and (2) the company has liabilities, or the bank gives cash or any other consideration in exchange for the securities. The rule also provides that these

affiliate by the unaffiliated borrower (for example, to purchase assets or securities from the inventory of an affiliate), the loan should be treated as a loan to the affiliate, and the affiliate's securities cannot be used to meet the collateral requirements of sections 23A. The loan must then be secured with other collateral in an amount and of a type that meets the requirements of section 23A for loans by a member bank to an affiliate.

34. In either case, the transaction must comply with section 23B; that is, the member bank must obtain the same amount of affiliate securities as collateral on the credit extension that the bank would obtain if the collateral were not affiliate securities.

35. Under the rule, a member bank may use the higher of the two valuation options for these transactions if, for example, the bank does not have the procedures and systems in place to verify the fair market value of affiliate securities.

transactions must be valued initially at the sum of (1) the total amount of consideration given by the member bank in exchange for the securities and (2) the total liabilities of the company whose securities have been acquired by the member bank. In effect, the rule requires member banks to treat such share donations and purchases in the same manner as if the member bank had purchased the assets of the transferred company at a purchase price equal to the liabilities of the transferred company (plus any separate consideration paid by the bank for the shares). (See 12 CFR 223.31.)

Similarly, when an affiliate donates a controlling block of an affiliate's shares to a member bank, a covered transaction occurs if the affiliate has liabilities that the member bank assumes. For example, the parent holding company of a member bank contributes between 25 percent and 100 percent of the voting shares of a mortgage company to the member bank. The parent holding company retains no shares of the mortgage company. The member bank gives no consideration in exchange for the transferred shares. The mortgage company has total assets of $300,000 and total liabilities of $100,000. The mortgage company's assets do not include any loans to an affiliate of the member bank or any other asset that would represent a separate covered transaction for the member bank upon consummation of the share transfer. As a result of the transaction, the mortgage company becomes an operating subsidiary of the member bank. The transaction is treated as a purchase of the assets of the mortgage company by the member bank from an affiliate under paragraph (a) of section 223.31. The member bank initially must value the transaction at $100,000, the total amount of the liabilities of the mortgage company. Going forward, if the member bank pays off the liabilities, the member bank must continue to value the covered transaction at $100,000. However, if the member bank sells $15,000 of the transferred assets of the mortgage company or if $15,000 of the transferred assets amortize, the member bank may value the covered transaction at $85,000.

Another situation is when a member bank acquires an affiliate by merger. Because a merger with an affiliate generally results in the member bank's acquiring all the assets of the affiliate and assuming all the liabilities of the affiliate, this transaction is effectively equivalent to the purchase and assumption transaction described in the previous paragraph. Accordingly, the merger transaction also is treated as a purchase of assets, and the covered-transaction amount is equal to the amount of any consideration paid by the member bank for the affiliate's assets (if any), plus the amount of any liabilities assumed by the bank in the transaction.[36]

The assets and liabilities of an operating subsidiary of a member bank are treated in the rule as assets and liabilities of the bank itself for purposes of section 23A.[37] The rule only imposes asset-purchase treatment on affiliate share transfers when the company whose shares are being transferred to the member bank was an affiliate of the bank before the transfer. If the transferred company was not an affiliate before the transfer, it would not be appropriate to treat the share transfer as a purchase of assets from an affiliate. Similarly, the rule only requires asset-purchase treatment for affiliate share transfers when the transferred company becomes a subsidiary and not an affiliate of the member bank through the transfer.

If a member bank purchases, or receives a donation, of a partial interest in an entity that remains an affiliate, that transaction is treated as a purchase of, or investment in, securities issued by an affiliate. This type of transaction is valued according to the purchase price or GAAP carrying value. (See 12 CFR 223.23.)

Step-Transaction Exemption (Section 223.31(d) and (e))

Under section 223.31(d) of the rule, an exemption is provided for certain step transactions that are treated as asset purchases under section 223.31(a) when an affiliate owned the transferred company for a limited period of time. Regulation W provides an exemption when a company acquires the stock of an unaffiliated company and, immediately after consummation of the acquisition, transfers the shares of the acquired company to the holding company's

36. As noted, section 223.3(dd) of the rule makes explicit the Board's view that these merger transactions generally involve the purchase of assets by a member bank from an affiliate.

37. Because a member bank usually can merge a subsidiary into itself, transferring all the shares of an affiliate to a member bank often is functionally equivalent to a transaction in which the bank directly acquires the assets and assumes the liabilities of the affiliate. In a direct acquisition of assets and assumption of liabilities, the covered transaction amount would be equal to the total amount of liabilities assumed by the member bank.

subsidiary member bank. For example, a BHC acquires 100 percent of the shares of an unaffiliated leasing company. At that time, the subsidiary member bank of the holding company notifies its appropriate federal banking agency and the Board of its intent to acquire the leasing company from its holding company. On the day after consummation of the acquisition, the holding company transfers all of the shares of the leasing company to the member bank. No material change in the business or financial condition of the leasing company occurs between the time of the holding company's acquisition and the member bank's acquisition. The leasing company has liabilities. The leasing company becomes an operating subsidiary of the member bank at the time of the transfer. This transfer by the holding company to the member bank, although deemed an asset purchase by the member bank from an affiliate under paragraph (a) of section 223.31, would qualify for the exemption in paragraph (d) of section 223.31.

The rule exempts these "step" transactions under certain conditions. First, the member bank must acquire the target company immediately after the company became an affiliate (by being acquired by the bank's holding company, for example).[38] The member bank must acquire the entire ownership position in the target company that its holding company acquired. Also, there must be no material change in the business or financial condition of the target company during the time between when the company becomes an affiliate of the member bank and when the bank is in receipt of the company. Finally, the entire transaction must comply with the market-terms requirement of section 23B, and the bank must notify its appropriate federal banking agency and the Board, at or before the time that the target company becomes an affiliate of the bank, of its intent ultimately to acquire the target company.

Regulation W requires that the bank consummate the step transaction immediately to ensure the quality and fairness of the transaction. To the extent that the member bank acquires the target company some time after the company becomes an affiliate, the transaction looks less like a single transaction in which the bank acquires the target company and more like two separate transactions, the latter of which involves the bank acquiring assets from an affiliate.

The Board recognized, however, that banking organizations may need a reasonable amount of time to address legal, tax, and business issues relating to an acquisition. Regulation W thus permits member banks to avail themselves of the step-transaction exemption if the bank acquires the target company within three months after the target company becomes an affiliate so long as the appropriate federal banking agency for the bank has approved the longer time period.

The 100 percent ownership requirement (that the member bank must acquire the entire ownership position in the target company that its holding company acquired) prevents a holding company from keeping the good assets of the target company and transferring the bad assets to the holding company's subsidiary member bank. If a banking organization fails to meet the terms of the step-transaction exemption, the organization may be able to satisfy the conditions of the rule's internal-corporate-reorganization exemption or may be able to obtain a case-by-case exemption from the Board.

Prohibition on the Purchase of Low-Quality Assets

Section 23A generally prohibits the purchase by a member bank of a low-quality asset from an affiliate.[39] In addition, a member bank cannot purchase or accept as collateral a low-quality asset from an affiliate. Section 23A defines a low-quality asset to include (1) an asset classified as "substandard," "doubtful," or "loss," or treated as "other loans specially mentioned," in the most recent report of examination or inspection by a federal or state supervisory agency (a "classified asset"); (2) an asset in nonaccrual status; (3) an asset on which payments are more than 30 days past due; or (4) an asset whose terms have been renegotiated or compromised due to the deteriorating financial condition of the obligor.[40] Any asset meeting one of the above four criteria, including securities and real

38. This exemption can be used only by BHCs that are in existence at the time of the transaction. A BHC in formation cannot take advantage of the exemption. For example, a leasing company that applies to become a BHC cannot use the exemption to transfer its leasing assets to the bank.

39. 12 USC 371c(a)(3). Section 23A does not prohibit an affiliate from donating a low-quality asset to a member bank, so long as the bank provides no consideration for the asset, and no liabilities are associated with the asset.

40. 12 USC 371c(b)(10).

property, is a low-quality asset.[41]

Regulation W expands the definition of low-quality assets in several respects. (See 12 CFR 223.3(v).) First, an asset is identified by examiners as a low-quality asset if they represent credits to countries that are not complying with their external debt-service obligations but are taking positive steps to restore debt service through economic adjustment measures, generally as part of an International Monetary Fund program. Although such assets may not be considered classified assets, examiners are to consider these assets in their assessment of a bank's asset quality and capital adequacy. See also section 7040.3 and SR-08-12.

Second, the rule considers a financial institution's use of its own internal asset-classification systems. The rule includes within the definition of low-quality asset not only assets classified during the last examination but also assets classified or treated as special mention under the institution's internal classification system (or assets that received an internal rating that is substantially equivalent to classified or special mention in such an internal system).

The purchase by a depository institution from an affiliate of assets that have been internally classified raises potentially significant safety-and-soundness concerns. The Board expects companies with internal rating systems to use the systems consistently over time and over similar classes of assets and will view as an evasion of section 23A any company's deferral or alteration of an asset's rating to facilitate sale of the asset to an affiliated institution.

Finally, the rule defines low-quality asset to include foreclosed property designated "other real estate owned" (OREO), until it is reviewed by an examiner and receives a favorable rating. It further defines as a low-quality asset any asset (not just real estate) that is acquired in satisfaction of a debt previously contracted (not just through foreclosure) if the asset has not yet been reviewed in an examination or inspection. Under the rule, if a particular asset is good collateral taken from a bad borrower, the asset should cease to be a low-quality asset upon examination.

Section 23A provides a limited exception to the general rule prohibiting purchase of low-quality assets if the bank performs an independent credit evaluation and commits to the purchase of the asset before the affiliate acquires the asset.[42] Section 223.15 of the rule also provides an exception from the prohibition on the purchase by a member bank of a low-quality asset from an affiliate for certain loan renewals. The rule allows a member bank that purchased a loan participation from an affiliate to renew its participation in the loan, or provide additional funding under the existing participation, even if the underlying loan had become a low-quality asset, so long as certain criteria were met. These renewals or additional credit extensions may enable both the affiliate and the participating member bank to avoid or minimize potential losses. The exception is available only if (1) the underlying loan was not a low-quality asset at the time the member bank purchased its participation and (2) the proposed transaction would not increase the member bank's proportional share of the credit facility. The member bank must also obtain the prior approval of its entire board of directors (or its delegees) and it must give a 20-days' post-consummation notice to its appropriate federal banking agency. A member bank is permitted to increase its proportionate share in a restructured loan by 5 percent (or by a higher percentage with the prior approval of the bank's appropriate federal banking agency). The scope of the exemption includes renewals of participations in loans originated by any affiliate of the member bank (not just affiliated depository institutions).

Financial Subsidiaries

Section 23A Statutory Provisions for Financial Subsidiaries

Section 23A has several special provisions that apply to covered transactions between a bank and its financial subsidiary. Section 23A defines a "financial subsidiary" as any company that is a subsidiary of a bank that would be a financial subsidiary of a national bank under section 5136A of the Revised Statutes of the United

41. The federal banking agencies generally consider non-investment-grade securities to be classified assets. See, for example, the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks (May 7, 1979) and also table 3 in section 2020.1 of this manual. Assets identified by examiners through the Shared National Credit and Interagency Country Exposure Review Committee processes also should be considered classified assets for purposes of section 23A.

42. 12 USC 371c(a)(3).

States.[43] Section 5136A, in turn, defines a financial subsidiary of a national bank as any company that is controlled by one or more IDIs, other than (1) a subsidiary that engages solely in activities that national banks are permitted to engage in directly (and subject to the same terms and conditions that apply to national banks) or (2) a national bank that is specifically authorized by the express terms of a federal statute (other than section 5136A), such as an Edge Act corporation or an SBIC.[44] Section 5136A also prohibits a financial subsidiary of a national bank from engaging in insurance underwriting, real estate investment and development, or merchant banking activities.[45]

The Dodd-Frank Act amended section 23A as it relates to financial subsidiaries of a bank. First, the 10 percent quantitative limit of section 23A between a bank and any individual affiliate now applies to covered transactions between a bank and any individual financial subsidiary of the bank. In addition, for purposes of section 23A, the amount of a bank's investment in its financial subsidiary includes the retained earnings of the financial subsidiary. See section 609(a) of the Dodd-Frank Act.

Section 23A generally applies only to transactions between (1) a bank and an affiliate of the bank and (2) a bank and a third party in which some benefit from either type of transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. Section 23A establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a bank and another affiliate of the bank. First, the FRA provides that any purchase of, or investment in, the securities of a bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem a loan or other extensions of credit made by a bank's affiliate to any financial subsidiary of a bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasion.

43. 12 USC 24a(g)(3).
44. 12 USC 24a(2).
45. 12 USC 371c(c)(1).

Regulation W Provisions for Financial Subsidiaries

Regulation W (1) defines a financial subsidiary of a bank, (2) exempts certain companies from the definition, and (3) sets forth special valuation and other rules for financial subsidiaries. (See sections 223.3(a)(8), 223.3(p), and 223.32 of the rule.) In section 223.32, Regulation W also includes, several special rules that apply to transactions for financial subsidiaries.

Applicability of the 10 percent quantitative limit to transactions with a financial subsidiary. The 10 percent quantitative limit in section 23A applies with respect to covered transactions between a member bank and any individual financial subsidiary of the bank.

Valuation of investments in securities issued by a financial subsidiary. Because financial subsidiaries of a member bank are considered affiliates of the bank for purposes of section 23A, a member bank's purchases of, and investments in, the securities of its financial subsidiary are covered transactions under the statute. The Dodd-Frank Act further provides that a member bank's investment in its own financial subsidiary, for purposes of section 23A, shall include the retained earnings of the financial subsidiary. In light of this statutory provision, section 223.32(b) of Regulation W contains a special valuation rule for investments by a member bank in the securities of its own financial subsidiary.[46] Such investments must be valued at the greater of (1) the price paid by the member bank for the securities or (2) the carrying value of the securities on the financial statements of the member bank (determined in accordance with GAAP but without reflecting the bank's pro rata share of any earnings retained or losses incurred by the financial subsidiary after the bank's acquisition of the securities).[47]

46. The rule's special valuation formula for investments by a member bank in its own financial subsidiary does not apply to investments by a member bank in a financial subsidiary of an affiliated depository institution. Such investments must be valued using the general valuation formula set forth in section 223.23 for investments in securities issued by an affiliate and, further, may trigger the anti-evasion rule contained in section 223.32(c)(1) of the rule.

47. The rule also makes clear that if a financial subsidiary is consolidated with its parent member bank under GAAP, the carrying value of the bank's investment in the financial subsidiary shall be determined based on parent-only financial statements of the bank.

The following examples were designed to assist banks in valuing investments in securities issued by a financial subsidiary of the bank. Each example involves a securities underwriter that becomes a financial subsidiary of the bank after the transactions described below.

Initial valuation.

- *Direct acquisition by a bank.* A bank pays $500 to acquire 100 percent of the shares of a securities underwriter. The initial carrying value of the shares on the member bank's parent-only GAAP financial statements is $500. The member bank initially must value the investment at $500.
- *Contribution of a financial subsidiary to a bank.* The parent holding company of a member bank acquires 100 percent of the shares of a securities underwriter in a transaction valued at $500 and immediately contributes the shares to the member bank. The member bank gives no consideration in exchange for the shares. The bank initially must value the investment at the carrying value of the shares on the bank's parent-only GAAP financial statements. Under GAAP, the bank's initial carrying value of the shares would be $500.

Anti-evasion rules as they pertain to financial subsidiaries. Section 23A generally applies only to transactions between a bank and an affiliate of the bank and transactions between a member bank and a third party when some benefit of the transaction accrues to an affiliate of the bank. The statute generally does not apply to transactions between two affiliates. The GLB Act establishes two special anti-evasion rules, however, that govern transactions between a financial subsidiary of a member bank and another affiliate of the bank.[48] First, the GLB Act provides that any purchase of, or investment in, securities issued by a member bank's financial subsidiary by an affiliate of the bank will be deemed to be a purchase of, or investment in, such securities by the bank itself. Second, the GLB Act authorizes the Board to deem an extension of credit made by a member bank's affiliate to any financial subsidiary of the bank to be an extension of credit by the bank to the financial subsidiary, if the Board determines that such action is necessary or appropriate to prevent evasions of the FRA or the GLB Act. Section 223.32(c) of the rule incorporates both of these provisions.

The Board exercised its authority under the second anti-evasion rule by stating that an extension of credit to a financial subsidiary of a bank by an affiliate of the bank would be treated as an extension of credit by the bank itself to the financial subsidiary if the extension of credit is treated as regulatory capital of the financial subsidiary. An example of the kind of credit extension covered by this provision would be a subordinated loan to a financial subsidiary that is a securities broker–dealer where the loan is treated as capital of the subsidiary under the SEC's net capital rules. Treating such an extension of credit as a covered transaction is appropriate because the extension of credit by the affiliate has a similar effect on the subsidiary's regulatory capital as an equity investment by the affiliate, which is treated as a covered transaction by the terms of the GLB Act (as described above). The rule generally does not prevent a BHC or other affiliate of a member bank from providing financial support to a financial subsidiary of the bank in the form of a senior or secured loan.

Collateral for Certain Transactions with Affiliates

Section 23A(c) requires a member bank's use of collateral for certain transactions between a member bank and its affiliates.[49] Each loan or extension of credit to an affiliate[50] or guarantee, acceptance, or letter of credit issued on behalf of an affiliate (herein referred to as credit transactions) by a member bank or its subsidiary, and any credit exposure of a member bank or a subsidiary to an affiliate resulting from a securities borrowing or lending transaction, or a derivatives transaction shall be secured at all times by collateral ("credit exposure") at the amounts required by the statute. The required collateral varies[51] depending on the type of collateral used to secure the transaction.[52]

48. GLB Act section 121(b)(1), codified at 12 USC 371c(e)(4)).

49. The bank must perfect the security interest in the collateral (*Fitzpatrick v. FDIC*, 765 F.2d 569 (6th Cir. 1985)). A purchase of assets from an affiliate does not require collateral.

50. 12 USC 371c(b)(7).

51. "Credit extended" means the loan or extension of credit, guarantee, acceptance, or letter of credit.

52. 12 USC 371c(c)(1).

The specific collateral requirements are—

1. 100 percent of the amount of such loan or extension of credit, guarantee, acceptance, letter of credit or credit exposure, if the collateral is composed of
   a. obligations of the United States or its agencies;
   b. obligations fully guaranteed by the United States or its agencies as to principal and interest;
   c. notes, drafts, bills of exchange, or banker's acceptances that are eligible for rediscount or purchase by a Federal Reserve Bank;[53] or
   d. a segregated, earmarked deposit account with the member bank that is for the sole purpose of securing a credit transaction between the member bank and its affiliates and is identified as such;
2. 110 percent of the amount of the credit extended if the collateral is composed of obligations of any state or political subdivision of any state;
3. 120 percent of the amount of the credit extended if the collateral is composed of other debt instruments, including receivables; or
4. 130 percent of the amount of the credit extended if the collateral is composed of stock, leases, or other real or personal property.

For example, a member bank makes a $1,000 loan to an affiliate. The affiliate posts as collateral for the loan $500 in U.S. Treasury securities, $480 in corporate debt securities, and $130 in real estate. The loan satisfies the collateral requirements of this section because $500 of the loan is 100 percent secured by obligations of the United States, $400 of the loan is 120 percent secured by debt instruments, and $100 of the loan is 130 percent secured by real estate. The statute prohibits a member bank from counting a low-quality asset toward section 23A's collateral requirements for credit transactions with affiliates.[54] A member bank must maintain a perfected security interest at all times in the collateral that secures the credit transaction.

Section 23A(c)(1) requires that credit transactions must meet the collateral requirements of the statute at all times. A low-quality asset cannot be used to satisfy the statute or the regulation's collateral requirements, but can be taken as additional collateral.

Collateral Requirements in Regulation W

The collateral requirements for credit transactions are found in section 223.14 of Regulation W.

Deposit Account Collateral. Under section 23A, a member bank may satisfy the collateral requirements of the statute by securing a credit transaction with an affiliate with a "segregated, earmarked deposit account" maintained with the bank in an amount equal to 100 percent of the credit extended.[55]

Member banks may secure covered transactions with omnibus deposit accounts so long as the member bank takes steps to ensure that the omnibus deposit accounts fully secure the relevant covered transactions. Such steps might include substantial overcollateralization or the use of subaccounts or other recordkeeping devices to match deposits with covered transactions. To obtain full credit for any deposit accounts taken as section 23A collateral, member banks must ensure that they have a perfected, first-priority security interest in the accounts. (See section 223.14(b)(1)(i)(D).)

Ineligible collateral. The purpose of section 23A's collateral requirements is to ensure that member banks that engage in credit transactions with affiliates have legal recourse, in the event of affiliate default, to tangible assets with a value at least equal to the amount of the credit extended.

The statute recognizes that certain types of assets are not appropriate to serve as collateral for credit transactions with an affiliate. In particular, the statute provides that low-quality assets and securities or other debt obligations issued by an affiliate are not eligible collateral for such covered transactions.[56]

Under section 223.14(c) of the rule, intangible assets also are not deemed acceptable to meet the collateral requirements imposed by

53. Regulation A includes a representative list of acceptable government obligations (12 CFR 201.108).
54. 12 USC 371c(c)(3).
55. 12 USC 371c(c)(1)(A)(iv).
56. 12 USC 371c (c)(3) and (4).

section 23A.[57] Intangible assets, including servicing assets, are particularly hard to value, and a member bank may have significant difficulty in collecting and selling such assets in a reasonable period of time.

Section 23A(c) requires that credit transactions with an affiliate be "secured" by collateral. A credit transaction between a member bank and an affiliate supported only by a guarantee or letter of credit from a third party does not meet the statutory requirement that the credit transaction be secured by collateral. Guarantees and letters of credit often are subject to material adverse change clauses and other covenants that allow the issuer of the guarantee or letter of credit to deny coverage. Letters of credit and guarantees are not balance-sheet assets under GAAP and, accordingly, would not constitute "real or personal property" under section 23A. There is a particularly significant risk that a member bank may have difficulty collecting on a guarantee or letter of credit provided by a nonaffiliate on behalf of an affiliate of the bank. Accordingly, guarantees and letters of credit are not acceptable section 23A collateral.[58]

As noted above, section 23A prohibits a member bank from accepting securities or other debt obligations issued by an affiliate as collateral for an extension of credit to any affiliate. The rule clarifies that securities issued by the member bank itself also are not eligible collateral to secure a credit transaction with an affiliate. Equity securities issued by a lending member bank, and debt securities issued by a lending member bank that count as regulatory capital of the bank, are not eligible collateral under section 23A. If a member bank were forced to foreclose on a credit transaction with an affiliate secured by such securities, the bank may be unwilling to liquidate the collateral promptly to recover on the credit transaction because the sale might depress the price of the bank's outstanding securities or result in a change in control of the bank. In addition, to the extent that a member bank is unable or unwilling to sell such securities acquired through foreclosure, the transaction would likely result in a reduction in the bank's capital, thereby offsetting any potential benefit provided by the collateral.

Perfection and priority. Under section 223.14(d) of the rule, a member bank's security interest in any collateral required by section 23A must be perfected in accordance with applicable law to ensure that a member bank has good access to the assets serving as collateral for its credit transactions with affiliates. This requirement ensures that the member bank has the legal right to realize on the collateral in the case of default, including a default resulting from the affiliate's insolvency or liquidation. A member bank also is required to either obtain a first-priority security interest in the required collateral or deduct from the amount of collateral obtained by the bank the lesser of (1) the amount of any security interests in the collateral that are senior to that obtained by the bank or (2) the amount of any credits secured by the collateral that are senior to that of the bank. For example, if a member bank lends $100 to an affiliate and takes as collateral a second lien on a parcel of real estate worth $200, the arrangement would only satisfy the collateral requirements of section 23A if the affiliate owed the holder of the first lien $70 or less (a credit transaction secured by real estate must be secured at 130 percent of the amount of the transaction).

The rule includes the following example of how to compute the section 23A collateral value of a junior lien: A member bank makes a $2,000 loan to an affiliate. The affiliate grants the member bank a second-priority security interest in a piece of real estate valued at $3,000. Another institution that previously lent $1,000 to the affiliate has a first-priority security interest in the entire parcel of real estate. This transaction is not in compliance with the collateral requirements of this section. Because of the existence of the prior third-party lien on the real estate, the effective value of the real estate collateral for the member bank for purposes of this section is only $2,000—$600 less than the amount of real estate collateral required by this section for the transaction ($2,000 x 130 percent = $2,600).

Unused portion of an extension of credit. Section 23A requires that the "amount" of an extension of credit be secured by the statutorily prescribed levels of collateral. Under the statute, if a member bank provides a line of credit to an affiliate, it must secure the full amount of the

57. The rule does not confine the definition of intangible assets by reference to GAAP.

58. The rule also provides that instruments "similar" to guarantees and letters of credit are ineligible collateral. For example, in the Board's view, a member bank cannot satisfy section 23A's collateral requirements by purchasing credit protection in the form of a credit-default swap referencing the affiliate's obligation.

line of credit throughout the life of the credit. Section 223.14(f)(2) of the rule, however, provides an exemption to the collateral requirements of section 23A for the unused portion of an extension of credit to an affiliate so long as the member bank does not have any legal obligation to advance additional funds under the credit facility until the affiliate has posted the amount of collateral required by the statute with respect to the entire used portion of the extension of credit.[59] In such credit arrangements, securing the unused portion of the credit line is unnecessary from a safety-and-soundness perspective because the affiliate cannot require the member bank to advance additional funds without posting the additional collateral required by section 23A. If a member bank voluntarily advances additional funds under such a credit arrangement without obtaining the additional collateral required under section 23A to secure the entire used amount (despite its lack of a legal obligation to make such an advance), the Board views this action as a violation of the collateral requirements of the statute. The entire amount of the line of credit counts against the bank's quantitative limit, even if the line does not need to be secured.

Purchasing affiliate debt securities in the secondary market. A member bank's investment in the debt securities issued by an affiliate is an extension of credit by the bank to the affiliate and thus is subject to section 23A's collateral requirements. Section 223.14(f)(3) of the rule provides an exemption that permits member banks in certain circumstances to purchase debt securities issued by an affiliate without satisfying the collateral requirements of section 23A. The exemption is available where a member bank purchases an affiliate's debt securities from a third party in a bona fide secondary-market transaction. When a member bank buys an affiliate's debt securities in a bona fide secondary-market transaction, the risk that the purchase is designed to shore up an ailing affiliate is reduced. Any purchase of affiliate debt securities that qualifies for this exemption would still remain subject to the quantitative limits of section 23A and the market-terms requirement of section 23B. In analyzing a member bank's good faith under this exemption transaction, examiners should look at the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase, the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities, any history of bank financing of the affiliate, and any other relevant information.

59. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. Moreover, the transaction is still subject to the 10 and 20 percent limits of the statute.

Credit transactions with nonaffiliates that become affiliates. Banks sometimes lend money to, or issue guarantees on behalf of, unaffiliated companies that later become affiliates of the bank. Section 223.21(b)(2) provides transition rules that exempt credit transactions from the collateral requirements in situations in which the member bank entered into the transactions with the nonaffiliate at least one year before the nonaffiliate became an affiliate of the bank.

For example, a member bank with capital stock and surplus of $1,000 and no outstanding covered transactions makes a $120 unsecured loan to a nonaffiliate. The member bank does not make the loan in contemplation of the nonaffiliate becoming an affiliate. Nine months later, the member bank's holding company purchases all the stock of the nonaffiliate, thereby making the nonaffiliate an affiliate of the member bank. The member bank is not in violation of the quantitative limits of the rule's section 223.11 or 223.12 at the time of the stock acquisition. The member bank is, however, prohibited from engaging in any additional covered transactions with the new affiliate at least until such time as the value of the loan transaction falls below 10 percent of the member bank's capital stock and surplus. The transaction counts towards the 20 percent limit for transactions for all affiliates. In addition, the member bank must bring the loan into compliance with the collateral requirements of section 223.14 promptly after the stock acquisition. Transactions with nonaffiliates in contemplation of the nonaffiliate becoming an affiliate must meet the quantitative and collateral requirements of the rule at the time of the inception of the credit transaction and of the affiliation.

Limitations on Collateral

Member banks may accept as collateral for covered transactions receivables, leases, or other real or personal property.[60] The following are limitations and collateral restrictions:

1. A low-quality asset is not acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, an affiliate or credit exposure to an affiliate resulting from a secured borrowing or lending transaction or derivative transaction.
2. Securities or other debt obligations issued by an affiliate of a member bank shall not be acceptable as collateral for a loan or extension of credit to, or for a guarantee, acceptance, or letter of credit issued on behalf of, or credit exposure from a securities borrowing or lending transaction or derivatives transaction to, that affiliate or any other affiliate of the member bank. The above collateral requirements are not applicable to an acceptance that is already fully secured either by attached documents or by other property that is involved in the transaction and has an ascertainable market value.

Derivative Transactions Between Insured Depository Institutions and Their Affiliates

Derivative transactions between a bank and its affiliates generally arise either from the risk-management needs of the bank or the affiliate. Transactions arising from the bank's needs typically arise when a bank enters into a swap or other derivative contract with a customer but chooses not to hedge directly the market risk generated by the derivative contract or is unable to hedge the risk directly because the bank is not authorized to hold the hedging asset. In order to manage the market risk, the bank may have an affiliate acquire the hedging asset. The bank would then do a "bridging" derivative transaction between itself and the affiliate maintaining the hedge.

Other derivative transactions between a member bank and its affiliate are affiliate-driven. A bank's affiliate may enter into an interest-rate or foreign-exchange derivative with the bank in order to accomplish the asset-liability management goals of the affiliate. For example, a BHC may hold a substantial amount of floating-rate assets but issue fixed-rate debt securities to obtain cheaper funding. The BHC may then enter into a fixed-to-floating interest-rate swap with its subsidiary bank to reduce the holding company's interest-rate risk.

Banks and their affiliates that seek to enter into derivative transactions for hedging purposes could enter into the desired derivatives with unaffiliated companies. Banks and their affiliates often choose to use each other as their derivative counterparties, however, in order to maximize the profits of, and manage risks within, the consolidated financial group.

Section 23A on Derivative Transactions

The Dodd-Frank Act provides that the credit exposure resulting from a derivative transaction with an affiliate is a covered transaction (12 USC 371c(b)(7)(G)). In addition, Regulation W requires the member bank to establish and maintain policies and procedures designed to manage the credit exposure arising from the derivative. These policies and procedures require, at a minimum, that the bank monitor and control its exposure to its affiliates by imposing appropriate credit controls and collateral requirements.

Regulation W provides that credit derivatives between an institution and an unaffiliated third party that reference the obligations of an affiliate of the institution, and that are the functional equivalent of a guarantee by the institution on behalf of an affiliate, should be treated as a guarantee by the institution on behalf of an affiliate for the purposes of section 23A.[61]

Section 23B and Regulation W Regarding Derivative Transactions

Derivative transactions between a member bank and an affiliate also are subject to section 23B of the FRA under the express terms of the statute.[62]

60. As noted above, letters of credit and mortgage servicing rights may not be accepted as collateral for purposes of section 23A. See 12 CFR 223.14(c)(4) and (5).

61. The novation of a derivative between a bank and its affiliate is treated as a purchase of assets under the statute.

62. In addition to applying to covered transactions, as defined in section 23A of the FRA, the market-terms requirement of section 23B of the FRA applies broadly to, among other things, "[t]he payment of money or the furnishing of services to an affiliate under contract, lease or otherwise" (12

In this regard, section 23B requires a member bank to treat an affiliate no better than a *similarly situated* nonaffiliate. Section 23B generally does not allow a member bank to use with an affiliate the terms and conditions it uses with its most creditworthy unaffiliated customer, unless the bank can demonstrate that the affiliate is of comparable creditworthiness as the bank's most creditworthy unaffiliated customer. Instead, section 23B requires that an affiliate be treated comparably (with respect to terms, conditions, and credit limits) to the majority of third-party customers engaged in the same business, and having comparable credit quality and size as the affiliate. Because a bank generally has the strongest credit rating within a holding company, the Board generally would not expect an affiliate to obtain better terms and conditions from a member bank than the member bank receives from its major unaffiliated counterparties. In addition, market terms for derivatives among major financial institutions generally include daily marks to market and two-way collateralization above a relatively small exposure threshold.

Covering Derivatives That Are the Functional Equivalent of a Guarantee

Section 223.33 of the rule provides that credit derivatives between a member bank and a nonaffiliate in which the bank protects the nonaffiliate from a default on, or a decline in the value of, an obligation of an affiliate of the bank are covered transactions under section 23A. Such derivative transactions are viewed as guarantees by a member bank on behalf of an affiliate (and, hence, are covered transactions) under section 23A.

The rule provides that these credit derivatives are covered transactions under section 23A and gives several examples.[63] A member bank is not allowed to reduce its covered-transaction amount for these derivatives to reflect hedging positions established by the bank with third parties. A credit derivative is treated as a covered transaction only to the extent that the derivative provides credit protection with respect to obligations of an affiliate of the member bank.

USC 371c-1(a)(2)(C)). Institution-affiliate derivatives generally involve a contract or agreement to pay money to the affiliate or furnish risk-management services to the affiliate.

63. This does not apply to guarantees, acceptances, and letters of credit issued on behalf of an affiliate. These instruments must be fully collateralized at inception. In most instances, the covered-transaction amount for such a credit derivative would be the notional principal amount of the derivative.

Exemptions from Section 23A

Section 23A exempts seven transactions or relations from its quantitative limits and collateral requirements.[64] Regulation W, subpart E, clarifies certain of these exemptions and exempts a number of additional types of transactions.

The Board reserves the right to revoke or modify any additional exemption granted by the Board in Regulation W, if the Board finds that the exemption is resulting in unsafe or unsound banking practices. The Board also reserves the right to terminate the eligibility of a particular member bank to use any such exemption if the bank's use of the exemption is resulting in unsafe or unsound banking practices.

Covered Transactions Exempt from the Quantitative Limits and Collateral Requirements

Under the rule's section 223.41, the quantitative limits (sections 223.11 and 223.12) and the collateral requirements (section 223.14) do not apply to the following transactions. The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and the prohibition on the purchase of a low-quality asset (section 223.15).

- *Parent institution/subsidiary institution transactions.* Transactions with a depository institution if the member bank controls 80 percent or more of the voting securities of the depository institution or the depository institution controls 80 percent or more of the voting securities of the member bank.
- *Purchase of loans on a nonrecourse basis from an affiliated depository institution.* Banks that are commonly controlled (i.e., at least 25 percent common ownership) can purchase loans on a nonrecourse basis. This allows chain banks and banks in companies that are not owned 80 percent by the same company to achieve the same efficiency as sister banks.

64. 12 USC 371c(d).

Sister-bank exemption (section 223.41(b)). Regulation W exempts transactions with a depository institution if the same company controls 80 percent or more of the voting securities of the member bank and the depository institution.[65] In addition, the statute provides that covered transactions between sister banks must be consistent with safe and sound banking practices.[66]

The sister-bank exemption, by its terms, only exempts transactions by a member bank with a sister-bank affiliate;[67] hence, the sister-bank exemption cannot exempt a member bank's extension of credit or other covered transaction to an affiliate that is not a sister bank (even if the extension of credit was purchased from a sister bank). For example, a member bank purchases from Sister-Bank Affiliate A a loan to Affiliate B in a purchase that qualifies for the sister-bank exemption in section 23A. The member bank's asset purchase from Sister-Bank Affiliate A would be an exempt covered transaction under section 223.41(b), but the member bank also would have acquired an extension of credit to Affiliate B, which would be a covered transaction between the member bank and Affiliate B under section 223.3(h)(1) that does not qualify for the sister-bank exemption.

Internal corporate reorganizations. Section 223.41(d) of Regulation W provides an exemption for asset purchases by a bank from an affiliate that are part of a one-time internal corporate reorganization of a banking organization.[68] The exemption includes purchases of assets in connection with a transfer of securities issued by an affiliate to a member bank, as described in section 223.31(a).

Under this exemption, a member bank would be permitted to purchase assets (other than low-quality assets) from an affiliate (including in connection with an affiliate share transfer that section 223.31 of the rule treats as a purchase of assets) exempt from the quantitative limits of section 23A if the following conditions are met.

First, the purchase must be part of an internal corporate reorganization of a holding company that involves the transfer of all or substantially all of the shares or assets of an affiliate or of a division or department of an affiliate to an IDI.[69] The asset purchase must not be part of a series of periodic, ordinary-course asset transfers from an affiliate to a member bank.[70] Second, the member bank's holding company must provide the Board with contemporaneous notice of the transaction and must commit to the Board to make the bank whole, for a period of two years, for any transferred assets that become low-quality assets.[71] Third, a majority of the member bank's directors must review and approve the transaction before consummation. Fourth, the section 23A value of the covered transaction must be less than 10 percent of the member bank's capital stock and surplus (or up to 25 percent of the bank's capital stock and surplus with the prior approval of the appropriate federal banking agency). Fifth, the holding company and all its subsidiary depository institutions must be well capitalized and well managed and must remain well capitalized upon consummation of the transaction.

65. Banks that are affiliated in this manner are referred to as "sister banks." Sister banks can improve their efficiency through intercorporate transfers under this exception. Also, "company" in this context is not limited to a BHC. For example, if a retail corporation owns two credit card banks, the two credit card banks would be sister banks, although owned by a retail corporation, and the sister-bank exemption could be used for transactions between two credit card banks.

66. A member bank and its operating subsidiaries are considered a single unit for purposes of section 23A. Under the statute and the regulation, transactions between a member bank (or its operating subsidiary) and the operating subsidiary of a sister IDI generally qualify for the sister-bank exemption.

67. The sister-bank exemption in section 23A does not allow a member bank to avoid any restrictions on sister-bank transactions that may apply to the bank under the prompt-corrective-action framework set forth in section 38 of the FDI Act (12 USC 1831o) and regulations adopted thereunder by the bank's appropriate federal banking agency.

68. See 1998 *Fed. Res. Bull.* 985 and 1013–14.

69. The notice also must describe the primary business activities of the affiliate whose shares or assets are being transferred to the member bank and must indicate the anticipated date of the reorganization.

70. The IDI must provide the Board, as well as the appropriate federal agency, a notice that describes the primary business activities of the affiliate whose shares or assets are being transferred to the IDI and must indicate the anticipated date of the reorganization.

71. The holding company can meet these criteria either by repurchasing the assets at book value plus any write-down that has been taken or by making a quarterly cash contribution to the bank equal to the book value plus any write-downs that have been taken by the bank. The purchase or payment must be made within 30 days of each quarter end. In addition, if a cash payment is made, the member bank will hold an amount of risk-based capital equal to the book value of any transferred asset that becomes low-quality so long as the bank retains ownership of the transferred asset. For example, under this dollar-for-dollar capital requirement, the risk-based capital charge for each transferred low-quality loan asset would be 100 percent (equivalent to a 1250 percent risk weight) rather than the 8 percent requirement (equivalent to a 100 percent risk weight) that would apply to a similar defaulted loan asset that is not a part of the transferred asset pool. See Board letter dated December 21, 2007, to Andres L. Navarette (Capital One Financial Corp.)

Covered Transactions Also Exempt from the Quantitative Limits, Collateral Requirements, and Low-Quality-Asset Prohibition

The quantitative limits (sections 223.11 and 223.12), the collateral requirements (section 223.14), and the prohibition on the purchase of a low-quality asset (section 223.15) do not apply to the following exempted transactions. (See section 223.42.) The transactions are, however, subject to the safety-and-soundness requirement (section 223.13) and certain conditions. Detailed conditions or restrictions pertaining to these exemptions are discussed after this list.

1. Making correspondent banking deposits in an affiliated depository institution (as defined in section 3 of the FDI Act (12 USC 1813)) or an affiliated foreign bank that represent an ongoing, working balance maintained in the ordinary course of correspondent business
2. Giving immediate credit to an affiliate for uncollected items received in the ordinary course of business
3. Transactions secured by cash or U.S. government securities
4. Purchasing securities of a servicing affiliate as defined by the BHC Act
5. Purchasing certain liquid assets
6. Purchasing certain marketable securities
7. Purchasing certain municipal securities
8. Purchasing from an affiliate an extension of credit subject to a repurchase agreement that was originated by a member bank and sold to the affiliate subject to a repurchase agreement or with recourse
9. Asset purchases from an affiliate by a newly formed member bank, if the appropriate federal banking agency for the member bank has approved the asset purchase in writing in connection with the review of the formation of the member bank
10. Transactions approved under the Bank Merger Act that involve affiliated federally IDIs and the U.S. branches and agencies of a foreign bank
11. Purchasing, on a nonrecourse basis, an extension of credit from an affiliate
12. Intraday extensions of credit
13. Riskless-principal transactions

Correspondent banking. Section 23A exempts from its quantitative limits and collateral requirements a deposit by a member bank in an affiliated bank or affiliated foreign bank that is made in the ordinary course of correspondent business, subject to any restrictions that the Board may impose.[72] Section 223.42(a) of the rule further provides that such deposits must represent ongoing, working balances maintained by the member bank in the ordinary course of conducting the correspondent business.[73] Although not required by section 23A or the Home Owners' Loan Act (HOLA), the rule also provides that correspondent deposits in an affiliated insured savings association are exempt if they otherwise meet the requirements of the exemption.

Secured credit transactions. Section 23A and section 223.42(c) of the rule exempt any credit transaction by a member bank with an affiliate that is "fully secured" by obligations of the United States or its agencies or obligations fully guaranteed by the United States or its agencies as to principal and interest.[74] A deposit account meets the "segregated, earmarked" requirement only if the account exists for the sole purpose of securing credit transactions between the member bank and its affiliates and is so identified. Under section 23A, if U.S. government obligations or deposit accounts are sufficient to fully secure a credit transaction, then the transaction is completely exempt from the quantitative limits of the statute. If, however, the U.S. government obligations or deposit accounts represent less than full security for the credit transaction, then the amount of U.S. government obligations or deposits counts toward the collateral requirements of section 23A, but no part of the transaction is exempt from the statute's quantitative limits.

The exemption provides that a credit transaction with an affiliate will be exempt "to the extent that the transaction is and remains secured" by appropriate (d)(4) collateral. If a member bank makes a $100 nonamortizing term loan to an affiliate that is secured by $50 of U.S. Treasury securities and $75 of real estate, the value of the covered transaction will be $50. If the market value of the U.S. Treasury securities falls to $45 during the life of the loan, the value

72. 12 USC 371c(d)(2).

73. Unlike the sister-bank exemption, the exemption for correspondent banking deposits applies to deposits placed by a member bank in an uninsured depository institution or foreign bank.

74. 12 USC 371c(d)(4). A partial list of such obligations can be found at 12 CFR 201.108.

of the covered transaction would increase to $55. The Board expects member banks that use this expanded (d)(4) exemption to review the market value of their U.S. government obligations collateral regularly to ensure compliance with the exemption.

Purchases of assets with readily identifiable market quotes. Section 23A(d)(6) exempts the purchase of assets by a member bank from an affiliate if the assets have a “readily identifiable and publicly available market quotation” and are purchased at their current market quotation. The rule (section 223.42(e)) limits the availability of this exemption (the (d)(6) exemption) to purchases of assets with market prices that are recorded in widely disseminated publications that are readily available to the general public, such as newspapers with a national circulation. Because as a general matter only exchange-traded assets are recorded in such publications, this test has ensured that the qualifying assets are traded actively enough to have a true “market quotation” and that examiners can verify that the assets are purchased at their current market quotation. The rule applies if the asset is purchased at or below the asset’s current market quotation.[75]

If a member bank purchases from one affiliate securities issued by another affiliate, the bank has engaged in two types of covered transactions: a purchase of securities from an affiliate and the investment in securities issued by an affiliate. Under the rule, although the (d)(6) exemption may exempt the one-time asset purchase from the first affiliate, it would not exempt the ongoing investment in securities being issued by the second affiliate.

The (d)(6) exemption may apply to a purchase of assets that are not traded on an exchange. In particular, purchases of foreign exchange, gold, and silver, and purchases of over-the-counter (OTC) securities and derivative contracts, whose prices are recorded in widely disseminated publications, may qualify for the (d)(6) exemption.

75. The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation’s price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

Purchases of Certain Marketable Securities under Regulation W. Regulation W provided an additional exemption from section 23A for certain purchases of securities by a member bank from an affiliate. The rule expanded the statutory (d)(6) exemption to allow a member bank to purchase securities from an affiliate based on price quotes obtained from certain electronic services so long as, among other things, the selling affiliate is a broker–dealer registered with the SEC, the securities have a ready market and are eligible for purchase by state member banks, the securities are not purchased within 30 days of an underwriting (if an affiliate of the bank is an underwriter of the securities), and the securities are not issued by an affiliate. All securities purchases are subject to section 23B.

- *Broker–Dealer Requirement.* Under Regulation W, the selling affiliate must be a broker–dealer securities affiliate that is registered with the SEC. Broker–dealers that are registered with the SEC are subject to supervision and examination by the SEC and are required by SEC regulations to keep and maintain detailed records concerning each securities transaction conducted by the broker–dealer. In addition, SEC-registered broker–dealers have experience in determining whether a security has a “ready market” under SEC regulations. The rule does not expand the exemption to include securities purchases from foreign broker–dealers. The rule explicitly provides, however, that a member bank may request that the Board exempt securities purchases from a particular foreign broker–dealer, and the Board would consider these requests on a case-by-case basis in light of all the facts and circumstances.
- *Securities eligible for purchase by a state member bank.* The exemption requires that the bank’s purchase of securities be eligible for purchase by a state member bank. For example, the Board determined that a member bank may purchase equity securities from an affiliate if the member bank’s purchase is made to hedge the bank’s permissible customer-driven equity derivative transaction. The purchase must be treated as a purchase of a security on the bank Call Report.
- *No purchases within 30 days of an underwriting.* The exemption generally prohibits a member bank from using the exemption to purchase securities during an underwriting, or within 30 days of an underwriting, if an

affiliate of the bank is an underwriter of the securities. This provision applies unless the security is purchased as part of an issue of obligations of, or obligations fully guaranteed as to principal and interest by, the United States or its agencies. The rule includes the 30-day requirement because of the uncertain and volatile market values of securities during and shortly after an underwriting period and because of the conflicts of interest that may arise during and after an underwriting period, especially if an affiliate has difficulty selling its allotment.

- *No securities issued by an affiliate.* If a member bank purchases from one affiliate securities issued by another affiliate, it would not exempt the investment in securities issued by the second affiliate, even though the (d)(6) exemption may exempt the asset purchase from the first affiliate. The transaction would be treated as a purchase of, or an investment in, securities issued by an affiliate.
- *Price-verification methods.* The (d)(6) exemption applies only in situations in which the member bank is able to obtain price quotes on the purchased securities from an unaffiliated electronic, real-time pricing service. The Board reaffirms its position that it would not be appropriate to use independent dealer quotations or economic models to establish a market price for a security under the (d)(6) exemption. A security that is not quoted routinely in a widely disseminated news source or a third-party electronic financial network may not trade in a sufficiently liquid market to justify allowing a member bank to purchase unlimited amounts of the security from an affiliate.
- *Record retention.* The rule expressly includes a two-year record-retention and supporting information requirement that is sufficient to enable the appropriate federal banking agencies to ensure that the member bank is in compliance with the terms of the (d)(6) exemption.

Purchasing municipal securities. Section 223.42(g) of the rule exempts a member bank's purchase of municipal securities from an affiliate if the purchase meets certain requirements.[76] First, the member bank must purchase the municipal securities from a broker–dealer affiliate that is registered with the SEC. Second, the municipal securities must be eligible for purchase by a state member bank, and the member bank must report the transaction as a securities purchase in its Call Report. Third, the municipal securities must either be rated by a nationally recognized statistical rating organization (NRSRO) or must be part of an issue of securities that does not exceed $25 million in size. Finally, the price for the securities purchased must be (1) quoted routinely on an unaffiliated electronic service that provides indicative data from real-time financial networks; (2) verified by reference to two or more actual independent dealer quotes on the securities to be purchased or securities that are comparable to the securities to be purchased; or (3) in the case of securities purchased during the underwriting period, verified by reference to the price indicated in the syndicate manager's written summary of the underwriting.[77] Under any of the three pricing options, the member bank must purchase the municipal securities at or below the quoted or verified price, and all purchases are subject to section 23B.

Purchases of assets by newly formed banks. Section 223.42(i) of the rule exempts a purchase of assets by a newly formed member bank from an affiliate if the appropriate federal banking agency for the bank has approved the purchase. This exemption allows companies to charter a new bank and to transfer assets to the bank free of the quantitative limits and low-quality-asset prohibition of section 23A.

Transactions approved under the Bank Merger Act. The Bank Merger Act exemption applies to transactions between a member bank and certain IDI affiliates. Section 223.42(j) exempts transactions between IDIs that are approved pursuant to the Bank Merger Act. The rule also makes the Bank Merger Act exemption available for mergers and other related transactions between a member bank and a U.S. branch or agency of an

76. Municipal securities are defined by reference to section 3(a)(29) of the Securities Exchange Act. That act defines municipal securities as direct obligations of, or obligations guaranteed as to principal or interest by, a state or agency, instrumentality, or political subdivision thereof, and certain tax-exempt industrial development bonds. (See 17 USC 78c(a)(29).)

77. Under the Municipal Securities Rulemaking Board's Rule G-11, the syndicate manager for a municipal bond underwriting is required to send a written summary to all members of the syndicate. The summary discloses the aggregate par values and prices of bonds sold from the syndicate account.

affiliated foreign bank, if the transaction has been approved by the responsible federal banking agency pursuant to the Bank Merger Act, and should help ensure that such transactions do not pose significant risks to the member bank. There is no regulatory exemption for merger transactions between a national bank and its nonbank affiliate. Any member bank merging or consolidating with a nonbank affiliate may be able to take advantage of the regulatory exemption for internal-reorganization transactions contained in section 223.41(d) of the rule.

Purchases of extensions of credit—the purchase exemption. Regulation W codified, with changes, the exemption that previously was found at 12 CFR 250.250. In general,

- The purchase of an extension of credit on a nonrecourse basis from an affiliate is exempt from section 23A's quantitative limits provided that—
  - — the extension of credit is originated by the affiliate,
  - — the member bank makes an independent evaluation of the creditworthiness of the borrower before the affiliate makes or commits to make the extension of credit,
  - — the member bank commits to purchase the extension of credit before the affiliate makes or commits to the extension of credit, and
  - — the member bank does not make a blanket advance commitment to purchase extensions of credit from the affiliate. (See section 223.42(k) of the rule.)

  The rule also includes a 50 percent limit on the amount of loans a bank may purchase from an affiliate under the purchase exemption. When a member bank purchases more than half of the extensions of credit originated by an affiliate, the purchases represent the principal ongoing funding mechanism for the affiliate. The member bank's status as the predominant source of financing for the affiliate calls into question the availability of alternative funding sources for the affiliate, places significant pressure on the bank to continue to support the affiliate through asset purchases, and reduces the bank's ability to make independent credit decisions with respect to the asset purchases.
- *"Substantial, ongoing funding" test.* The rule allows the appropriate federal banking agency for a member bank to reduce the 50 percent threshold prospectively, on a case-by-case basis, in those situations in which the agency believes that the bank's asset purchases from an affiliate under the exemption may cause harm to the bank.
- *Independent credit review by the bank.* To qualify for the purchase exemption under section 223.42(k), a member bank must independently review the creditworthiness of the borrower before committing to purchase each loan. Under established Federal Reserve guidance, a bank is required to have clearly defined policies and procedures to ensure that it performs its own due diligence in analyzing the credit and other risks inherent in a proposed transaction.[78] This function is not delegable to any third party, including affiliates of the member bank. Accordingly, to qualify for this exemption, the member bank, independently and using its own credit policies and procedures, must itself review and approve each extension of credit before giving a purchase commitment to its affiliate.
- *Purchase of loans from an affiliate must be without recourse.* In connection with a bank's purchase of loans from an affiliate, the affiliate cannot retain recourse on the loans. The rule (section 223.42(k)) specifies that the exemption does not apply in situations where the affiliate retains recourse on the loans purchased by the member bank. The rule also specifies that the purchase exemption only applies in situations where the member bank purchases loans from an affiliate that were originated by the affiliate. The exemption cannot be used by a member bank to purchase loans from an affiliate that the affiliate purchased from another lender. The exemption is designed to facilitate a member bank's using its affiliate as an origination agent, not to permit a member bank to take off an affiliate's books loans that the affiliate purchased from a third party.

Intraday extensions of credit. Section 223.42(l) of the rule provides that intraday credit extensions by a member bank to an affiliate are extensions of credit under section 23A covered transactions but exempts all such intraday credit extensions from the quantitative and collateral requirements of section 23A if the member bank

78. See, for example, SR-97-21.

(1) maintains policies and procedures for the management of intraday credit exposure and (2) has no reason to believe that any affiliate receiving intraday credit would have difficulty repaying the credit in accordance with its terms. The establishment of policies and procedures are for—

- monitoring and controlling the credit exposure arising at any one time from the member bank's intraday extensions of credit to each affiliate and all affiliates in the aggregate and
- ensuring that any intraday extensions of credit by the member bank to an affiliate comply with the market-terms requirement of section 223.51 of the rule.

Standard under which the Board may grant additional exemptions. The FDIC, OCC, and the Board may grant additional section 23A exemptions requested on a case-by-case basis for the institutions they supervise. The FDIC must find that the exemptions do not present unacceptable risk to the insurance fund. In addition, the Board and the FDIC must find that the exemptions are in the public interest.

Exemptions and Interpretation from the Attribution Rule of Section 23A

The attribution rule of section 23A provides that "a transaction by a member bank with any person shall be deemed a transaction with an affiliate to the extent that the proceeds of the transaction are used for the benefit of, or transferred to, that affiliate" (12 USC 371c(a)(2)). One respective interpretation and three exemptions are discussed below.

Interpretation—Loans to a nonaffiliate that purchases securities or other assets through a depository institution affiliate agent or broker. In Regulation W, the Board issued an interpretation (12 CFR 223.16(b)) regarding a member bank's loan to a nonaffiliate that purchases assets through an institution's affiliate that is acting as agent. This interpretation confirms that section 23A of the FRA does not apply to extensions of credit an IDI grants to customers that use the loan proceeds to purchase a security or other asset through an affiliate of the depository institution, so long as (1) the affiliate is acting exclusively as an agent or broker in the transaction and (2) the affiliate retains no portion of the loan proceeds as a fee or commission for its services.

Under this interpretation, the Board concluded that when the affiliated agent or broker retains a portion of the loan proceeds as a fee or commission, the portion of the loan not retained by the affiliate as a fee or commission would still be outside the coverage of section 23A. On the other hand, the portion of the loan retained by the affiliate as a fee or commission would be subject to section 23A because it represents proceeds of a loan by a depository institution to a third party that are transferred to, and used for the benefit of, an affiliate of the institution. The Board, however, granted an exemption from section 23A for that portion of a loan to a third party that an affiliate retains as a market-rate brokerage or agency fee. (See 12 CFR 223.16(c)(2).)

The interpretation would not apply if the securities or other assets purchased by the third-party borrower through the affiliate of the depository institution were issued or underwritten by, or sold from the inventory of, another affiliate of the depository institution. In that case, the proceeds of the loan from the depository institution would be transferred to, and used for the benefit of, the affiliate that issued, underwrote, or sold the assets on a principal basis to the third party.

The above-mentioned transactions are subject to the market-terms requirement of section 23B, which applies to "any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or any other person" (12 USC 371c-1(a)(2)(D)). A market-rate brokerage commission or agency fee refers to a fee or commission that is no greater than that prevailing at the same time for comparable agency transactions the affiliate enters into with persons who are neither affiliates nor borrowers from an affiliated depository institution. (See Regulation W at 12 CFR 223.16(b).)

Exemption—Loans to a nonaffiliate that purchases securities from a depository institution securities affiliate that acts as a riskless principal. The Board has granted an exemption in Regulation W from section 23A of the FRA for extensions of credit by an IDI to customers who use the loan proceeds to purchase a security that is issued by a third party via a broker–dealer affiliate of the institution that acts as riskless principal. The exemption for riskless-principal transactions would not apply if the broker-

–dealer affiliate sold to the third-party borrower securities that were issued or underwritten by, or sold out of the inventory of, an affiliate of the depository institution. Riskless-principal trades, although the functional equivalent of securities brokerage transactions, involve the purchase of a security by the depository institution's broker–dealer affiliate. Accordingly, the broker–dealer retains the loan proceeds at least for some moment in time.

There is negligible risk that loans a depository institution makes to borrowers to engage in riskless-principal trades through a broker–dealer affiliate of the depository institution would be used to fund the broker–dealer. For this reason, the Board adopted an exemption from section 23A to cover riskless-principal securities transactions engaged in by depository institution borrowers through broker–dealer affiliates of the depository institution. This exemption is applicable even if the broker–dealer retains a portion of the loan proceeds as a market-rate markup for executing the riskless-principal securities trade. (See Regulation W at 12 CFR 223.16(c)(1) and (2).

Exemption—Depository institution loan to a nonaffiliate pursuant to a preexisting line of credit and the proceeds are used to purchase securities from the institution's broker–dealer affiliate. The Board approved an exemption in Regulation W from section 23A for loans by an IDI to a nonaffiliate pursuant to a preexisting line of credit, in which the loan proceeds are used to purchase securities from a broker–dealer affiliate. In more detail, the Board exempted extensions of credit by an IDI to its customers that use the credit to purchase securities from a registered broker–dealer affiliate of the institution, so long as the extension of credit is made pursuant to, and consistent with any conditions imposed in, a preexisting line of credit. This line of credit should not have been established in expectation of a securities purchase from or through an affiliate of the institution. The preexisting requirement is an important safeguard to ensure that the depository institution did not extend credit for the purpose of inducing a borrower to purchase securities from or issued by an affiliate. The preexisting line of credit exemption may not be used in circumstances in which the line has merely been preapproved. (See Regulation W at 12 CFR 223.16(c)(3)).

Exemption—Credit card transactions. Regulation W also provides an exemption from section 23A's attribution rule for general-purpose credit card transactions that meet certain criteria. (See section 223.16(c)(4).) The rule defines a general-purpose credit card as a credit card issued by a member bank that is widely accepted by merchants that are not affiliates of the bank (such as a Visa card or Mastercard) if less than 25 percent of the aggregate amount of purchases with the card are purchases from an affiliate of the bank. Extensions of credit to unaffiliated borrowers pursuant to special-purpose credit cards (that is, credit cards that may only be used or are substantially used to buy goods from an affiliate of the member bank) are subject to the rule.

The credit card exemption includes several different methods that are provided for a member bank to demonstrate that its credit card meets the 25 percent test. If a member bank has no commercial affiliates (other than those permitted for a financial holding company (FHC) under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if the bank has no reason to believe that it would fail the test. (A member bank could use this method of complying with the 25 percent test even if, for example, the bank's FHC controls, under section 4(a)(2), 4(c)(2), or 4(k)(4)(H) of the BHC Act, several companies engaged in nonfinancial activities.) Such a member bank would not be obligated to establish systems to verify strict, ongoing compliance with the 25 percent test. If a member bank has commercial affiliates (beyond those permitted for an FHC under section 4 of the BHC Act), the bank would be deemed to satisfy the 25 percent test if—

- the bank establishes systems to verify compliance with the 25 percent test on an ongoing basis and periodically validates its compliance with the test or
- the bank presents information to the Board demonstrating that its card would comply with the 25 percent test. (One way that a member bank could demonstrate that its card would comply with the 25 percent test would be to show that the total sales of the bank's affiliates are less than 25 percent of the total purchases by cardholders.)

Second, for those member banks that fall out of compliance with the 25 percent test, there is a three-month grace period to return to compliance before extensions of credit under the card become covered transactions. Third, member banks that are required to validate that their ongoing compliance with the 25 percent test have a fixed method, time frames, and examples for computing compliance.

Example of calculating compliance with the 25 percent test. A member bank seeks to qualify a credit card as a general-purpose credit card under section 223.16, paragraph (c)(4)(ii)(A), of the rule. The member bank assesses its compliance under paragraph (c)(4)(iii) of this section on the 15th day of every month (for the preceding 12 calendar months). The credit card qualifies as a general-purpose credit card for at least three consecutive months. On June 15, 2005, however, the member bank determines that, for the 12-calendar-month period from June 1, 2004, through May 31, 2005, 27 percent of the total value of products and services purchased with the card by all cardholders were purchases of products and services from an affiliate of the member bank. Unless the credit card returns to compliance with the 25 percent limit by the 12-calendar-month period ending August 31, 2005, the card will cease to qualify as a general-purpose credit card as of September 1, 2005. Any outstanding extensions of credit under the credit card that were used to purchase products or services from an affiliate of the member bank would become covered transactions at such time.

Application of Sections 23A and 23B of Subpart G to U.S. Branches and Agencies of Foreign Banks

Applicability of sections 23A and 23B to foreign banks engaged in underwriting insurance, underwriting or dealing in securities, merchant banking, or insurance company investment in the United States. By its terms, sections 23A and 23B of the FRA do not apply to the U.S. branches, agencies, or commercial lending offices of foreign banks. The Board, however, used its authority that it was granted by the GLB Act to impose restrictions on transaction between the branches, agencies, and lending offices and any affiliate of the foreign bank that operates in the United States in order to ensure that such transactions met certain prudential standards and provided competitive equality with U.S. banking organizations. The Board accomplished these goals by imposing the definition of affiliate of sections 23A and 23B on transactions between the branches, agencies, and lending offices and those affiliates if the company is also

1. directly engaged in the United States in certain activities. These activities are significant because a U.S. bank cannot engage in these activities directly or through an operating subsidiary, and the 23A and 23B limitations help ensure competitive equality between U.S. banks and foreign banks. These activities are as follows:
   - Insurance underwriting pursuant to section 4(k)(4)(B) of the Bank Holding Company Act (12 U.S.C. 1843(k)(4)(B));
   - Securities underwriting, dealing, or market making pursuant to section 4(k)(4)(E) of the Bank Holding Company Act (12 USC 1843(k)(4)(E));
   - Merchant banking activities pursuant to section 4(k)(4)(H) of the Bank Holding Company Act (12 USC 1843(k)(4)(H)) (but only to the extent that the proceeds of the transaction are used for the purpose of funding the affiliate's merchant banking activities);
   - Insurance company investment activities pursuant to section 4(k)(4)(I) of the Bank Holding Company Act (12 USC 1843(k)(4)(I)); or
   - Any other activity designated by the Board.
2. a portfolio company (as defined in the merchant banking subpart of Regulation Y (12 CFR 225.177(c))) controlled by the foreign bank or an affiliate of the foreign bank or a company that would be an affiliate of the branch, agency, or commercial lending company of the foreign bank under paragraph (a)(9) of section 223.2 if such branch, agency, or commercial lending company were a member bank; or
3. a subsidiary of an affiliate as described in paragraph (b)(1) or (2) of section 223.61.

Regulation W also provides that for purposes of subpart G, the "capital stock and surplus" of a U.S. branch, agency, or commercial lending company of a foreign bank will be determined by reference to the capital of the foreign bank as calculated under its home country capital standards.

SECTION 23B OF THE FEDERAL RESERVE ACT

Section 23B of the FRA became law on August 10, 1987, as part of the Competitive Equality Banking Act of 1987. This section also regulates transactions with affiliates. Section 23B applies to any covered transactions with an affiliate but excludes banks from the term "affiliate" as that term is defined in section 23A.

Regulation W, subpart F, sets forth the principal restrictions of section 23B. These include (1) a requirement that most transactions between a member bank and its affiliates be on terms and circumstances that are substantially the same as those prevailing at the time for comparable transactions with nonaffiliates; (2) a restriction on a member bank's purchase as fiduciary of assets from an affiliate unless certain criteria are met; (3) a restriction on a member bank's purchase, during the existence of an underwriting syndicate, of any security if a principal underwriter of the security is an affiliate; and (4) a prohibition on publishing an advertisement or entering into an agreement stating that a member bank will be responsible for the obligations of its affiliates. For the most part, subpart F restates the operative provisions of section 23B. The following transactions with affiliates are covered by section 23B:

- any covered transaction with an affiliate
- the sale of securities or other assets to an affiliate, including assets subject to repurchase
- the payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise
- any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person
- any transaction or series of transactions with a nonaffiliate if an affiliate—
  - — has a financial interest in the third party or
  - — is a participant in the transaction or series of transactions

Any transaction by a member bank or its subsidiary with any person is deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or are transferred to, the affiliate. A member bank and its subsidiaries may engage in the transactions covered by section 23B of the FRA only on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to the bank or its subsidiary, as those prevailing at the time for comparable transactions with, or that in good faith would be offered to, nonaffiliate companies.

Section 23B restricts the following transactions with affiliates:

- A member bank or its subsidiary cannot purchase as fiduciary any securities or other assets from any affiliate unless the purchase is permitted—
  - — under the terms of the instrument creating the fiduciary relationship,
  - — by court order, or
  - — by the law of the jurisdiction governing the fiduciary relationship.
- A member bank or its subsidiary, whether acting as principal or fiduciary, cannot knowingly purchase or acquire, during the existence of any underwriting or selling syndicate, any security if a principal underwriter of that security is an affiliate of the bank. This limitation applies unless the purchase or acquisition of the security has been approved before it is initially offered for sale to the public by a majority of the directors of the bank. The purchase should be based on a determination that it is a sound investment for the bank irrespective of the fact that an affiliate of the bank is a principal underwriter of the securities.

Transactions Exempt from Section 23B of the Federal Reserve Act

The market-terms requirement of section 23B applies to, among other transactions, any "covered transaction" between a member bank and an affiliate.[79] Section 23B(d)(3) makes clear that the term "covered transaction" in section 23B has the same meaning as the term "covered transaction" in section 23A but does not include any transaction that is exempt under section 23A(d)—for example, transactions between sister banks,[80] transactions fully secured by a deposit account or U.S. government obligations, and purchases of assets from an affiliate at a

79. 12 USC 371c-1(a)(2)(A).

80. Although transactions between banks are exempt from section 23B, the safety-and-soundness provisions of section 23A apply and generally require that transactions be conducted on terms similar to those terms and standards outlined in section 23B.

readily identifiable and publicly available market quotation.[81] Consistent with the statute, Regulation W's section 223.52(a)(1) exempts from section 23B any transaction that is exempt under section 23A(d).[82]

The rule also excludes from section 23B any covered transaction that is exempt from section 23A under section 223.42(i) or (j) (that is, asset purchases by a newly formed member bank and transactions approved under the Bank Merger Act). The Board excluded from section 23B this additional set of transactions because, in each case, the appropriate federal banking agency for the member bank involved in the transaction should ensure that the terms of the transaction are not unfavorable to the bank.

Other transactions that are exempt from section 23A are subject to section 23B, however. The purchase of marketable securities, municipal securities, and extensions of credit are subject to the market terms requirement of section 23B. In addition, intraday extensions of credit and riskless principal transactions between an IDI and an affiliate are subject to the market terms requirement of the statute and regulation. (See 12 CFR 223.52(a)(1) and 223.42(f), (g), (k), (1), and (m).)

Purchases of Securities for Which an Affiliate Is the Principal Underwriter

The GLB Act amended section 23B to permit a member bank to purchase securities during an underwriting conducted by an affiliate if the following two conditions are met. First, a majority of the directors of the member bank (with no distinction drawn between inside and outside directors) must approve the securities purchase before the securities are initially offered to the public. Second, such approval must be based on a determination that the purchase would be a sound investment for the member bank regardless of the fact that an affiliate of the bank is a principal underwriter of the securities.[83] Section 223.53(b) includes this standard and clarifies that if a member bank proposes to make such a securities purchase in a fiduciary capacity, then the directors of the bank must base their approval on a determination that the purchase is a sound investment for the person on whose behalf the bank is acting as fiduciary.

A member bank may satisfy this director-approval requirement by obtaining specific prior director approval of each securities acquisition otherwise prohibited by section 23B(b)(1)(B). The rule clarifies, however, that a member bank also satisfies this director-approval requirement if a majority of the directors of the bank approves appropriate standards for the bank's acquisition of securities otherwise prohibited by section 23B(b)(1)(B), and each such acquisition meets the standards adopted by the directors. In addition, a majority of the member bank's directors must periodically review such acquisitions to ensure that they meet the standards and must periodically review the standards to ensure they meet the "sound investment" criterion of section 23B(b)(2). The appropriate period of time between reviews would vary depending on the scope and nature of the member bank's program, but such reviews should be conducted by the directors at least annually. Before the passage of the GLB Act, Board staff informally allowed member banks, based on the legislative history of section 23B, to meet the director-approval requirement in this fashion, and there is no indication that Congress in the GLB Act intended to alter the procedures that a member bank could use to obtain the requisite director approval.[84] The rule codifies staff's preexisting approach to the director-approval requirement.[85]

81. 12 USC 371c-1(d)(3).

82. Regulation W will again be subsequently referred to as the "rule" or by its specified section-numbered discussion of section 23B provisions.

83. 12 USC 371c-1(b)(2). The rule provides that a U.S. government obligation is an eligible (d)(6) asset only if the obligation's price is quoted routinely in a widely disseminated publication that is readily available to the general public. Although all U.S. government obligations have low credit risk, not all U.S. government obligations trade in liquid markets at publicly available market quotations.

84. The conference report accompanying the Competitive Equality Banking Act of 1987 stated that the prior-approval requirement of section 23B(b) could be met "by the establishment in advance of specific standards by the outside directors for such acquisitions. If the outside directors establish such standards, they must regularly review acquisitions to assure that the standards have been followed, and they must periodically review the standards to assure that they continue to be appropriate in light of market and other conditions." See H.R. Conf. Rep. No. 100-261 at 133 (1987).

85. The rule also provides, consistent with existing Board interpretations, that a U.S. branch, agency, or commercial lending company of a foreign bank may comply with this requirement by obtaining the required approvals and reviews from either a majority of the directors or a majority of the senior executive officers of the foreign bank.

Definition of Affiliate Under Section 23B

Section 23B states that the term "affiliate" under section 23B has the meaning given to such term in section 23A except that the term "affiliate" under section 23B does not include a "bank," as defined in section 23A.[86] In the case of the sister-bank exemption, the rule's section 223.2(c) clarifies that the only companies that qualify for the "bank" exception to section 23B's definition of affiliate are insured depository institutions.

86. 12 USC 371c-1(d)(1).

Advertising and Guarantee Restriction

In section 23B(c), the "advertising restriction" prohibits a member bank from publishing any advertisement or entering into any agreement stating or suggesting that the bank shall in any way be responsible for the obligations of its affiliates. Regulation W clarifies this restriction to permit such guarantees and similar transactions if the transaction satisfies the quantitative and collateral restrictions of section 23A.[87] The rule also clarifies that section 23B(c) does not prohibit a member bank from making reference to such a guarantee, acceptance, or letter of credit in a prospectus or other disclosure document, for example, if otherwise required by law.

87. 12 USC 371c-1(c).

Regulation W: Transactions Between Member Banks and Their Affiliates

Examination Objectives

Effective date May 2001

Section 6070.2

1. To determine compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
2. To determine the relationships between the bank and its affiliates and the effects of those relationships and their transactions on the operations and safety and soundness of the bank.
3. To initiate corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

Regulation W: Transactions Between Member Banks and Their Affiliates

Examination Procedures

Effective date November 2003

Section 6070.3

1. *Section 23A of the Federal Reserve Act (12 USC 371c), Relations with Affiliates, and the Board's Regulation W.* By coordinating work with the examiners assigned to the various loan areas, determine compliance with laws and regulations pertaining to related organizations by performing the following procedures.
   a. Obtain a listing of loans to affiliates.
   b. Compare the listing with the bank's customer liability records to determine the list's accuracy and completeness.
   c. Obtain a listing of other covered transactions with affiliates (that is, for example, purchase of securities issued by an affiliate, purchase of assets, acceptance of securities issued by an affiliate as collateral for a loan to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate).
   d. Conduct transaction testing of intercompany affiliate transactions[1] for compliance with the limitations of section 23A of the Federal Reserve Act and the Board's Regulation W (see SR-03-02) by—
      - reviewing—
        - — the time elapsed between the original issuance of the affiliate's debt securities and the bank's purchase,
        - — the existence of any relevant agreements or relationships between the bank and the third-party seller of the affiliate's debt securities,
        - — any history of bank financing of the affiliate, and
        - — any other relevant information;
      - documenting any violations or potential violations, and reaching an agreement with the directors and senior management to resolve violations quickly; and
      - considering the inclusion of defaulted country risk problem assets in the evaluation of asset quality and capital adequacy. (See section 7040.1.)
   e. Ensure that transactions with affiliates meet the collateral requirements of section 23A.
   f. Ensure that low-quality loans have not been purchased from an affiliate.
   g. Determine that all transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
   h. *Policies and procedures.*
      - Obtain the bank's policies and procedures to determine compliance with sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W.
      - Ensure the policies and procedures cover all relevant affiliates (e.g., financial subsidiaries and joint ventures) and transactions covered by section 23A, and verify that the bank treats "sponsored and advised" companies as affiliates ("Sponsored and advised" companies would include, at a minimum, any company that receives investment advice and administrative services on a contractual basis from a member bank, whose trustees or managers are selected by the bank, and that has a name similar to that of the bank.).
      - Ensure that the policies and procedures are comprehensive and include adequate controls—
        - — to identify covered transactions and
        - — to ensure that necessary steps are performed for identified transactions (e.g., the required collateralization of loans to affiliates).
   i. *Covered transactions.*
      - If the controls for section 23A are considered adequate, use the list of covered transactions provided by the bank.
      - If controls are considered inadequate (for example, for transactions testing), review the bank's general ledger to identify transactions that are covered transactions.
      - Verify that covered transactions count against required limits and are collateralized when required.

1. Examples of affiliates include a bank holding company and its nonbank subsidiaries, companies under the member bank's control (see Regulation W, section 223.3(g)), any mutual fund advised by a member bank, merchant banking investments, a member bank or affiliate serving as a general partner in a partnership, and affiliates' subsidiaries. In addition, certain joint venture companies, ESOPs of banks and their affiliates, and special-purpose entities are affiliates if the regulatory definitions of control are met.

- If the bank uses an internal rating system for its assets, determine that the bank has not deferred or altered an asset's rating to facilitate sale of the asset to an affiliate.
- Review controls for monitoring compliance with the established limits and for collateralizing required credit-extension transactions.
- If controls are considered inadequate (for example, for transactions testing), ensure that covered transactions are properly valued.
- Verify that identified covered transactions comply with the limits of sections 23A and 23B (If the covered transactions do not comply with the limits, criticize the bank for inadequate controls, and discuss what steps the bank will use to correct the violations).
- Obtain collateral listings, and verify that necessary covered transactions are adequately collateralized:
  - — Verify that the values of omnibus deposit accounts used to secure covered transactions are sufficient to fully secure the relevant covered transactions.
  - — Review collateral documentation to ensure that the bank's interest is adequately perfected and prioritized (Regulation W, section 223.14(d)).

j. *Corporate lending (funding).* Ensure that there is compliance with the collateral requirements and quantitative limits:
- Obtain the bank's ″trial balances″ of loans.
- Check that loans to affiliates are included on the list of "covered transactions" and included in measurements for compliance with the quantitative limits. If some loans are not included, ascertain why.
- If an exemption is being used, verify that its application is correct.
- Verify that the loans are collateralized (using collateral listings), and review the documentation to ensure proper collateralization.

k. *Verification of exemptions.*
- For renewal of participations involving problem loans (see Regulation W, section 223.15(b)) involving nondepository affiliates, review supporting documentation to ensure that—
  - — the loan was not low quality at the time the bank purchased the participation,
  - — the renewal is approved at the board committee or senior management level as appropriate, and
  - — the bank's share of the renewal does not exceed its original share by more than 5 percent (unless approved by an appropriate federal bank regulator) and that the bank notified the federal bank regulator within 20 days.
- For retail lending (e.g., credit cards and mortgage banking) involving the funding of loans and the purchase of loans, ensure compliance with quantitative limits (for funding and compliance with collateral requirements) as follows:
  - — For credit card examinations, obtain the "trial balances" of the outstanding balances, and for mortgage banking, obtain lists of the loans sold.
  - — Check that credit card amounts generated by bank affiliates and mortgage loans sold to the bank by affiliates are included on the list of covered transactions and in measurements for compliance with the quantitative limits. If they are not included, ascertain why.
  - — If an exemption is being used, verify that its use is correct.
  - — Verify that loans are collateralized (using collateral), and review the documentation to ensure proper collateralization.
- For the general-purpose credit card exemption (Regulation W, section 223.16(c)(4)), verify, through review of relevant documentation, that the bank can demonstrate that its credit card meets the less than 25 percent test through one of three available methods. (An exemption from the attribution rule for extensions of credit under a general-purpose credit card is defined as one on which "less than 25 percent of the aggregate amount of purchases are purchases from a bank affiliate.")
  - — The bank has no commercial affiliates.
  - — The bank establishes systems to verify compliance with the less than 25 percent test on an ongoing basis.

— The bank presents information to the Board of Governors to demonstrate its card would comply.
- For purchases of extensions of credit—the "250.250 exemption" (Regulation W, section 223.42(k))—review supporting documentation to ensure that—
  — the member bank makes an independent creditworthiness evaluation before the affiliate makes or commits to make the loan,
  — the bank commits to make the loan purchase before the affiliate makes the loan,
  — the bank does not make a blanket advance commitment to purchase loans, and
  — the purchases from the affiliate by the depository institution and all depository institution affiliates in the prior 12 months represent 50 percent or less of all loans originated by the affiliate during such period.

l. If the bank is critically undercapitalized (under prompt-corrective-action rules), determine if the bank has engaged in any covered transaction, as defined in section 23A, without the prior approval of the FDIC or FRS.

m. *Internal controls.*
- Determine the bank's methods for identifying transactions subject to sections 23A and 23B of the Federal Reserve Act. Determine if these methods adequately identify such transactions. Consider the following information:
  — internal reports (Management should document any covered transactions with affiliates.)
  — loan records
  — deposit accounts
  — accounts payable and receivable
  — board minutes
- Determine if management understands what services its affiliates provide.
- Determine the volume and frequency of inter-institution transactions, such as loan participations or sales, purchases or sales of other assets, bank stock loans, insider transactions, and contractual obligations for services. Review these transactions for possible noncompliance or abusive practices.
- Review any formal or informal agreements regarding covered transactions. Determine if management adequately documents the cost, fee structure, and quality of services.
- Determine the bank's compliance with any outstanding conditions of an approved order or commitment issued by the regulator.

n. Determine if the affiliates are in compliance with the capital requirements of their functional regulator.

o. If the bank has used the expanded (d)(4) exemption, determine that the bank regularly reviews the market value of its U.S. government obligations collateral.

p. Determine that the bank's program for monitoring and controlling the credit exposure from derivative transactions with affiliates includes, at a minimum, imposing appropriate credit limits, mark-to-market or fair value requirements, and collateral requirements.

q. Determine that the limits and requirements reflect the nature, volume, and complexity of the bank's derivatives transactions.

r. Determine that the limits and requirements on credit exposures from derivative transactions have been approved by the board of directors of the bank or an appropriate board committee.

s. Determine that the bank's program for monitoring and controlling the credit exposure from intraday extensions of credit to affiliates includes, at a minimum, imposing appropriate credit limits (on a per-affiliate and aggregate basis) and collateral requirements.

t. Determine that that the limits and requirements imposed by the bank reflect the volume of intraday credit transactions and the reasons for those transactions.

u. Determine that the limits and requirements on intraday credit transactions have been approved by the board of directors of the bank or an appropriate board committee.

2. *Section 23B of the Federal Reserve Act (12 USC 371c-1), Restrictions on Transactions with Affiliates, and the Board's Regulation W*

a. Determine that covered transactions with affiliates comply with the restrictions in section 23B.

b. If the bank has derivative transactions with affiliates, determine that the bank has treated the affiliate no better than a similarly situated nonaffiliate.

c. Determine that management and other fees paid by the bank have a direct relationship to the value of the actual goods and services rendered, based on reasonable costs consistent with current market values for such goods and services.
d. Review any mortgage banking activity and servicing contracts with affiliates, if applicable. Give particular attention to—
   - the capacity in which the affiliate is acting,
   - the nature of the services provided,
   - the billing arrangement, frequency of billing, method of computation, and the basis for fees,
   - the method of compensating the bank for balances maintained and net interest earned on warehouse loans and lines of credit (This method should not be preferential.),
   - the pricing of loan and servicing-right sales,
   - advertising restrictions (for noncompliance).

INTRODUCTION

The examination of bank-related organizations must be of sufficient scope to determine a bank's compliance with laws and to evaluate its investments through an appraisal of related organizations' assets, earnings, management, and operations. In addition, the examination must fully disclose the nature of the relationships between the bank and its related organizations, as well as the effects of these relationships on the operations and safety and soundness of the bank.

FORMS OF RELATED ORGANIZATIONS

Various laws, rulings, and regulations have permitted banks to expand their services by forming or acquiring related organizations. Examples include

- the purchase for its own account, shares of a corporation that performs functions that the bank is empowered to perform directly; and
- authorization by specific laws to invest in various statutory subsidiaries, including Edge Act subsidiaries and agreement corporations.

In addition, a bank also may be controlled by an individual or company that controls other bank or nonbank entities. Regardless of the legal organizational structure between a bank and a related organization, a sound financial and satisfactory management relationship between both groups is essential to the bank's operation. Related organizations may assume several forms, as described in this section. Section 23A and 23B of the Federal Reserve Act (FRA) define the relationship between banks and affiliates.[1]

Affiliates

Affiliates are defined in subsection (b)(1) of section 23A of the FRA. Generally an affiliate is a company that is under common control with the bank. In addition, section 23A specifically states that certain entities are not considered affiliates of a member bank. See this manual's section entitled, "Transactions Between Member Banks and Their Affiliates," regarding the detailed provisions of section 23A and section 23B of the FRA, and Regulation W.

1. See 12 USC 371c and c-1.

Operations Subsidiaries

The Board has authorized member banks to establish and own operations subsidiaries. "Operations subsidiaries" are bank subsidiaries that engage in activities in which the bank could otherwise engage directly.

Member Bank Purchases of Stock of Operations Subsidiaries

The Board concluded in 1968 that "...a member bank may purchase for its own account shares of a corporation to perform, at locations at which the bank is authorized to engage in business, functions that the bank is empowered to perform directly" (12 CFR 250.141(i)). The Board reasoned that this authority could reasonably be interpreted as within a bank's incidental powers to ''organize its operations in the manner that it believes best facilitates the performance thereof,'' and that the subsidiary essentially constitutes a separately incorporated division or department of the bank.

No specific rule requires a state member bank to give the Board prior notice of, or to acquire the Board's approval for, the acquisition of an operations subsidiary to engage in activities that the bank itself may perform lawfully. However, section 208.3(d)(2) of Regulation H (12 CFR 208.3(d)(2)) prohibits a state member bank from causing or permitting a change in the general character of its business or in the scope of its corporate powers approved at the time of admission to membership, except with the permission of the Board.

Transactions between a State Member Bank and Its Operations Subsidiary

In general, section 23A exempts covered transactions between a bank and its operating subsidiary. In general, an operating subsidiary is a subsidiary that engages in activities that the bank can engage directly or are specifically authorized by federal law.

Operations Subsidiary Not Wholly Owned

The previously mentioned 1968 interpretation only expressly authorized state member banks to establish wholly owned operations subsidiaries in that a wholly owned subsidiary of a bank is functionally indistinguishable from a division or department of the bank. In enacting the Gramm-Leach-Bliley Act (GLB Act), Congress recognized the authority of national and state member banks to own and control an operations subsidiary. The GLB Act recognized traditional operations subsidiaries by distinguishing them from financial subsidiaries. The definition of financial subsidiary excludes a company engaged solely in activities that a parent bank may perform, subject to the limitations that govern the conduct of these activities.

The GLB Act also does not require that a state member bank own 100 percent of an operations subsidiary or a financial subsidiary. The GLB Act defines the term "subsidiary" by reference to the Bank Holding Company (BHC) Act. Under the BHC Act, a company is a "subsidiary" of a bank holding company if the BHC (1) owns or controls 25 percent or more of the company's voting shares or (2) controls the election of a majority of the company's directors.[2]

The Board thus believes that, as a result of the GLB Act and consistent with section 5136 of the Revised Statutes (12 USC 24 (Seventh)) and the Board's 1968 interpretation, a state member bank may acquire shares of a company that is not wholly owned and that (1) on consummation of the acquisition would be a subsidiary of the bank within the meaning of the BHC Act, and (2) engages only in activities in which the parent bank may engage, at locations at which the bank may engage in the activities, subject to the same limitations as if the bank were engaging in the activities directly.

2. See 12 USC 1841(d). A company also is considered a subsidiary of a bank holding company if the Board determines, after notice and opportunity for a hearing, that the bank holding company directly or indirectly exercises a controlling influence over the management or policies of the company.

FINANCIAL SUBSIDIARIES

Qualifying state member banks may control or hold an interest in a "financial subsidiary." A financial subsidiary is any company that is controlled by one or more insured depository institutions and engages in activities that are financial in nature or incidental to a financial activity. A financial subsidiary does not include (1) a subsidiary that the state member bank is specifically authorized to hold by the express terms of federal law (other than by section 9 of the FRA), such as an Edge Act subsidiary held under section 25 of the FRA, or (2) a subsidiary that engages only in activities that the parent bank could conduct directly and that are conducted on the same terms and conditions that govern the conduct of the activity by the state member bank. Financial subsidiaries are authorized for national banks by section 5136A of the Revised Statutes (12 USC 24a) and for state banks by section 46 of the Federal Deposit Insurance Act (FDI Act) (12 USC 1831w). To implement the authorization for state member banks, a new subpart G was added to Regulation H (12 CFR 208.71 et seq.).

Investing in or Controlling a Financial Subsidiary

Under the GLB Act, a state member bank may control, or hold an interest in, a financial subsidiary only if

- the state member bank and each of its depository institution affiliates are well capitalized and well managed;[3]
- the aggregate consolidated total assets of all the bank's financial subsidiaries do not exceed the lesser of 45 percent of the consolidated total assets of the bank or $50 billion;[4]
- the state member bank, if it is one of the 100

3. An institution is "well capitalized" if it meets or exceeds the capital levels designated by the institution's appropriate federal banking agency (section 38 of the FDI Act (12 USC 1831o)). A depository institution will be deemed "well managed" by references to specific examination ratings, or if the depository institution has not been examined by its federal or state banking agency and its federal banking agency determines that the existence and use of managerial resources are satisfactory (see 12 CFR 208.77(h)(ii)).

4. This dollar amount will be adjusted based on an indexing mechanism that is established jointly by the Federal Reserve Board and the Secretary of the Treasury.

largest insured banks, meets the following debt-rating or alternative debt-rating requirements:

- for the 50 largest insured banks, the bank must have at least one issue of outstanding eligible debt that is currently rated in one of the three highest investment-grade rating categories by a nationally recognized statistical rating organization;[5]
- for the next 50 largest insured banks, the bank must meet the issuer-credit-rating requirement for the 50 largest insured banks or the bank must meet the alternative criteria established jointly by regulation by the Secretary of the Treasury and the Federal Reserve[6] (the debt-rating and alternative criteria are not applicable if the bank's financial subsidiaries engage in any newly authorized financial activities solely as agent and not as principal); and

• the state member bank obtains the Federal Reserve's approval to engage in the activities of the financial subsidiary (using the notice procedures in section 208.76 of Regulation H). The state member bank also must obtain any necessary approvals from its state supervisory authority.

Issuer-Credit-Rating Requirement

The issuer-credit-rating requirement of Regulation H (12 CFR 208.71(b)(ii)) requires a long-term issuer credit rating from a nationally recognized statistical rating organization that is within the three highest investment-grade rating categories used by the organization. An "issuer credit rating" is one that assesses the bank's overall capacity and willingness to pay, on a timely basis, its unsecured financial obligations. An issuer credit rating differs from a debt rating in that it does not assess the bank's ability or willingness to make payments on any individual class or issue of debt, nor does it reflect payment priority or payment preferences among financial obligations.

5. "Eligible debt" refers to unsecured debt that has an initial maturity of more than 360 days. The debt must be issued and outstanding, may not be supported by any form of credit enhancement, and may not be held in whole or any significant part by affiliates or insiders of the bank or by any other person acting on behalf of or with funds from the bank or an affiliate.

6. The size of an insured bank is determined based on the consolidated total assets of the bank as of the end of each calendar year.

Under Regulation H, the issuer credit rating must be assigned to the national or state member bank that controls or holds an interest in a financial subsidiary if the bank is subject to section 208.71(b)(ii) of Regulation H. Issuer credit ratings that are assigned to a subsidiary or affiliate of the parent bank, such as a subsidiary engaged in derivatives activities, do not meet the regulation's requirements. Rating organizations may issue long-term or short-term issuer credit ratings for the same bank and separate ratings for dollar-denominated and foreign-currency-denominated obligations. Only long-term issuer ratings for dollar-denominated obligations satisfy the requirements of the regulation. A "long-term credit rating" is a written opinion that is issued by a nationally recognized statistical rating organization regarding the bank's overall capacity and willingness to pay on a timely basis its unsecured, dollar-denominated financial obligations maturing in no less than one year.

Prudential Standards

A state member bank that owns a financial subsidiary must comply with certain prudential safeguards. These standards pertain to the bank's capital requirements and its establishment of policies and procedures arising from financial subsidiary ownership.

As for the capital requirements, the state member bank must "deconsolidate" the assets and liabilities of all of its financial subsidiaries from those of the bank. Although the GLB Act requires a bank to deconsolidate the assets and liabilities of any financial subsidiary for regulatory capital purposes, a financial subsidiary remains a subsidiary of a state member bank. The Board will continue to review the operations and financial and managerial resources of the bank on a consolidated basis as part of the supervisory process. The Board may take appropriate supervisory action if it believes that the bank does not have the appropriate financial and managerial resources (including capital resources and risk-management controls) to conduct its direct or indirect activities in a safe and sound manner.

In addition to the deconsolidation described above, the bank must also deduct a specified percentage of the aggregate amount of the equity investment (including retained earnings) ("the aggregate amount") in all financial subsidiaries from the bank's calculation of its risk-based capital, leverage, and tangible equity ratios. In particular, the bank must make the following deductions:

- 50 percent of the aggregate amount from both the bank's tier 1 capital and its tier 2 capital for purposes of determining its risk-based capital ratios;
- 50 percent of the aggregate amount from the bank's tier 1 capital for purposes of determining its leverage ratios; and
- 100 percent of the aggregate amount from its tangible equity for purposes of determining its tangible equity capital ratio. It must also deduct 100 percent of the aggregate amount from the bank's risk-weighted assets, average total assets, and total assets when determining its risk-based, leverage, and tangible capital ratios.

The bank must meet all capital requirements—including the "well-capitalized" requirement (Regulation H, section 208.71) and the capital levels established by the Board under section 38 of the FDI Act—after the adjustments described above. Beginning on January 1, 2014, for a state member bank that is an advanced approaches bank, and beginning on January 1, 2015, for all state member banks, a state member bank that controls or holds an interest in a financial subsidiary must comply with the rules set forth in §217.22(a)(7) of Regulation Q (12 CFR 217.22(a)(7)) in determining its compliance with applicable regulatory capital standards (including the well capitalized standard of section 208.71(a)(1)).

The member bank must also establish and maintain policies and procedures to manage the financial and operational risks associated with its ownership of a financial subsidiary. These procedures must identify and manage financial and operational risks with the bank and its financial subsidiaries. They must adequately protect the bank from such risks and preserve the bank's separate corporate identity and the limited liability of the bank and its financial subsidiaries. In addition, a financial subsidiary of a state member bank is considered an affiliate of the bank for purposes of sections 23A and 23B of the FRA and a subsidiary of the BHC (and not a subsidiary of a bank) for the purposes of the anti-tying prohibitions of the BHC Act Amendments of 1970.

Permissible Activities for a Financial Subsidiary

A financial subsidiary can engage in three types of permissible activities:

1. Those activities that are determined to be closely related to banking, activities determined to be usual in connection with the transaction of banking abroad, and activities that are financial in nature or incidental to financial activities under section 4(k)(4) of the BHC Act. These permissible activities include
   - general insurance agency activities in any location and travel agency activities;
   - underwriting, dealing in, and making a market in all types of securities; and
   - any activity that the Federal Reserve determined by regulation or order to be closely related to banking or managing or controlling banks so as to be a proper incident thereto and that was in effect on the effective date of the GLB Act. (See section 225.86 of the Board's Regulation Y (12 CFR 225.86).)
2. Activities that the Secretary of the Treasury, in consultation with the Board, determines to be financial in nature or incidental to financial activities and permissible for financial subsidiaries of national banks pursuant to section 5136A(b) of the Revised Statutes of the United States (12 USC 24a(b)).
3. Activities that the state member bank is permitted to engage in directly under state law, subject to the same terms and conditions that govern the conduct of the activity by the state member bank (12 USC 24a(a)(2)(A)(ii)).

Impermissible Activities for a Financial Subsidiary

As discussed in 12 CFR 208.72(b), a financial subsidiary may not engage in the following activities: (1) as principal in insurance underwriting (except to the extent permitted for national banks by the Comptroller of the Currency as of January 1, 1999, and not subsequently overturned in certain grandfathered title insurance activities); (2) providing or issuing annuities; (3) real estate investment or development (except as expressly authorized by law); and (4) merchant banking and insurance company investment activities.

Federal Reserve Approval Requirements

Federal Reserve approval of a financial subsidiary involves a streamlined notice procedure. A state member bank must file a notice with the appropriate Reserve Bank before acquiring control of, or an interest in, a financial subsidiary, or before engaging in an additional financial activity through an existing financial subsidiary. No notice is required for a financial subsidiary to engage in an additional activity that the parent state member bank could conduct directly. The notice must include basic information on the financial subsidiary and its existing and proposed activities. In the case of an acquisition, the notice should include a description of the transaction through which the bank proposes to acquire control of, or an interest in, the financial subsidiary. The notice also must contain a certification that the state member bank and its depository institution affiliates meet the capital, management, and credit-rating requirements to own a financial subsidiary, as stated in the GLB Act and subpart G of Regulation H. If the notice is for the state member bank's initial affiliation with a company engaged in insurance activities, the notice must describe the company's insurance activities and identify the states where the company holds an insurance license. A notice will be considered approved on the 15th day after receipt of a complete notice by the appropriate Reserve Bank, unless before that date, the notice is approved or denied or the bank is notified that additional time is needed to review the submitted notice.

The GLB Act permits a state member bank to acquire an interest in or control a financial subsidiary if the bank meets the criteria and requirements set forth in Regulation H. The Board, however, retains its general supervisory authority for state member banks and may restrict or limit the activities of, or the acquisition or ownership of a subsidiary by, a state member bank if the Board finds that the bank does not have the appropriate financial and managerial resources to conduct the activities or to acquire or retain ownership of the company.

AGRICULTURAL CREDIT CORPORATIONS

Most agricultural credit corporations are under the direct supervision of the district Federal Intermediate Credit Bank (FICB) where the corporations discount most of their loans. However, an agricultural credit corporation may obtain funds exclusively in the open market and avoid FICB regulation.

For agricultural credit corporations, the central point of contact or the examiner-in-charge normally decides when to examine such an entity. A complete analysis of the entity's activities should always be performed if

- the corporation is not supervised by the Federal Intermediate Credit Bank (FICB),
- the most recent FICB examination occurred over a year ago, or
- the most recent FICB examination indicates that the corporation is in less than satisfactory condition.

The extent of any analysis should be based on the examiner's assessment of the corporation's effect on the parent bank. That analysis should include, but not be limited to, a review of

- asset quality;
- the volatility, maturity, and interest-rate sensitivity of the asset and liability structures; and
- the bank's liability for guarantees issued on behalf of the corporation.

When the same borrower is receiving funds from both the corporation as well as the parent bank and the combined exposure exceeds 25 percent of total consolidated capital, the debt should be detailed on the concentration section of the examination report. The consolidation procedures listed in the instructions for the preparation of Consolidated Reports of Condition and Income should be used when consolidating the figures of the corporation with those of its parent.

EDGE ACT AND AGREEMENT CORPORATIONS

U.S.-based corporations and permissible activities for their Edge Act and agreement corporation subsidiaries are described in detail in the

Board's Regulation K (12 CFR 211 subpart A). Edge Act and agreement corporations provide banks with a vehicle for engaging in international banking or foreign financial operations. They also have the power, with supervisory consent, to purchase and hold the stock of foreign banks and other international financial concerns. Edge Act and agreement corporations are examined by the Federal Reserve, and their respective reports of examination should be reviewed during each examination of a parent member bank. The examiner should review the Federal Reserve examination report and also the amount and quality of negotiable instruments (e.g., commercial paper) held when evaluating the bank's investment in the Edge corporation.

Transactions between the parent bank and the bank's Edge Act and agreement corporation subsidiaries are not subject to the limitations in section 23A and the Board's Regulation W. However, they are subject to limitations under section 25 of the FRA (12 USC 601) and under the Board's Regulation K. In addition, transactions with such bank subsidiaries and the parent bank's affiliates are aggregated with transactions by the bank and its affiliates for purposes of section 23A limitations and restrictions. Transactions between a bank and Edge Act and agreement corporation subsidiaries of the bank's holding company are subject to section 23A.

FOREIGN BANKING ORGANIZATIONS

Under section 211.21(o) of Regulation K (12 CFR 211.21(o)), the term foreign banking organization includes

- a foreign bank, as defined in section 1(b)(7) of the International Banking Act (12 USC 3101(7)) that
  - — operates a branch, agency, or commercial lending company subsidiary in the United States;
  - — controls a bank in the United States; or
  - — controls an Edge corporation acquired after March 5, 1987; and any company of which the foreign bank is a subsidiary.

On March 15, 2006, the Board approved a revision to Regulation K (effective April 19, 2006), incorporating the provisions of section 208.63 of Regulation H by reference into sections 211.5 and 211.24 of Regulation K. Edge and agreement corporations and other foreign banking organizations (that is, U.S. branches, agencies, and representative offices of foreign banks that are supervised by the Federal Reserve) must establish and maintain procedures reasonably designed to ensure and monitor compliance with the Bank Secrecy Act and related regulations. Each of these banking organizations' compliance programs must include, at a minimum, (1) a system of internal controls to ensure ongoing compliance, (2) independent testing of compliance by the institution's personnel or by an outside party, (3) the designation of an individual or individuals responsible for coordinating and monitoring day-to-day compliance, and (4) training for appropriate personnel. (See 12 CFR part 211.)

FOREIGN BANKS

The Board's Regulation K defines a *foreign bank* in subpart A (12 CFR 211.2(j)), which governs the foreign activities of U.S banking organizations. Under subpart A, a foreign bank

- is organized under the laws of a foreign country;
- engages directly in the business of banking;
- is recognized as a bank by the bank supervisory or monetary authority of the country of its organization or principal banking operations;
- receives deposits to a substantial extent in the regular course of its business; and
- has the power to accept demand deposits.

The Board's Regulation K also defines a *foreign bank* in subpart B (12 CFR 211.21(n)), which pertains to foreign banking organizations. Under subpart B, a foreign bank

- is an organization that is organized under the laws of a foreign country;
- engages directly in the business of banking; and
- does not include a central bank of a foreign country that does not engage or seek to engage in a commercial banking business in the United States through an office.

U.S. OFFICES OF FOREIGN BANKS

Regulation K (12 CFR 211.21(t)) defines a *foreign bank office* as any branch, agency, representative office, or commercial lending company subsidiary of a foreign bank operating in the United States.

Branches of a Foreign Bank

A *branch of a foreign bank* is defined (12 CFR 211.21(e)) as any place of business of a foreign bank, located in any state, at which deposits are received, and that is not an agency.

Agencies

Regulation K (12 CFR 211.21(b)) defines an *agency* of a foreign bank as any place of business of a foreign bank, located in any state, at which credit balances are maintained, checks are paid, money is lent, or, to the extent not prohibited by state or federal law, deposits are accepted from a person or entity that is not a citizen or resident of the United States. Obligations are not to be considered credit balances unless they are

- incidental to, or arise out of the exercise of, other lawful banking powers;
- to serve a specific purpose;
- not solicited from the general public;
- not used to pay routine operating expenses in the United States such as salaries, rent, or taxes;
- withdrawn within a reasonable period of time after the specific purpose for which they were placed has been accomplished; and
- drawn upon in a manner reasonable in relation to the size and nature of the account.

Commercial Lending Company

A *commercial lending company* is defined as any organization, other than a bank or an organization operating under section 25 of the FRA (12 USC 601-604a), organized under the laws of any state, that maintains credit balances permissible for an agency and engages in the business of making commercial loans. A commercial lending company includes any company chartered under article XII of the banking law of the state of New York. (See Regulation K, section 211.21(g) (12 CFR 211.21(g)).)

Representative Office

A *representative office* is defined as any office of a foreign bank that is located in any state and is not a federal branch, federal agency, state branch, state agency, or commercial lending company subsidiary. (See section 211.21(x) of Regulation K (12 CFR 211.21(x)).) A representative office is usually established when a bank's board of directors and management desire to establish a physical presence in a foreign market and very limited functions are to be (or can be made) available. A representative office cannot provide traditional banking services, such as accepting deposits or making loans directly. The office generally serves as a liaison and marketing vehicle for the parent bank in the United States.

A U.S. subsidiary of a foreign bank may be considered to be a representative office of the foreign bank when it holds itself out to the public as a representative of the foreign bank that is acting on behalf of the foreign bank, even if the subsidiary engages in other nonbank business. In addition, an individual or a unit of a subsidiary that acts as a representative of a foreign bank from the location of the nonbank subsidiary may be treated as a representative office. A representative office may make credit decisions only if

- the foreign bank also operates one or more branches or agencies in the United States,
- the loans approved at the representative office are made by a U.S. office of the bank, and
- the loan proceeds are not disbursed in the representative office.

(See section 211.24(d)(1)(ii) of Regulation K (12 CFR 211.24(d)(1)(ii)).)

CORRESPONDENT BANKS

A correspondent bank provides certain services to banks located in other countries that do not have local offices or whose local office is prohibited from engaging in certain activities. Such a relationship allows a foreign bank to provide trade-related and foreign-exchange services for its multinational customers in a foreign market without having to establish a physical presence in that market.

PARALLEL-OWNED BANKING ORGANIZATIONS

A parallel-owned banking organization is created when at least one U.S. depository institution and a foreign bank[7] are controlled, either directly or indirectly, by the same person or group of persons[8] who are closely associated in their business dealings or otherwise acting in concert. Parallel-owned banking organizations do not include structures in which one depository institution is a subsidiary of the other or in which the organization is controlled by a company subject to the BHC Act or the Savings and Loan Holding Company Act.[9] The banking agencies[10] consider whether "control" of a depository institution exists when a person or group of persons controls 10 percent or more of any class of the depository institution's voting shares. Parallel-owned banking organizations are established and maintained for a variety of reasons, including tax and estate planning and the potential risks associated with nationalization. While these reasons may be legitimate and not prohibited by U.S. or foreign law, the structure of such organizations creates or increases certain risks and may make it more difficult for supervisors to monitor and address those risks. On April 23, 2002, the U.S. banking agencies issued a joint agency statement that addresses the potential risks associated with parallel-owned banking organizations. The existence of one or more of the following factors may, depending on the circumstances, warrant additional inquiry regarding the existence of a parallel banking organization:

- An individual or group of individuals acting in concert that controls a foreign bank also controls any class of voting shares of a U.S. depository institution, or financing for persons owning or controlling the shares that are received from, or arranged by, the foreign bank, especially if the shares of the U.S. depository institution are collateral for the stock-purchase loan.
- The U.S. depository institution has adopted particular or unique policies or strategies similar to those of the foreign bank, such as common or joint marketing strategies, sharing of customer information, cross-selling of products, or linked websites.
- An officer or director of the U.S. depository institution either (1) serves as an officer or director[11] of a foreign bank or (2) controls a foreign bank or is a member of a group of individuals acting in concert or with common ties that controls a foreign bank.
- The name of the U.S. depository institution is similar to that of the foreign bank.

Parallel-owned banking organizations present supervisory risks similar to those arising from chain-banking organizations in the United States. The fundamental risk presented by these organizations is that they may be acting in a de facto organizational structure that, because it is not formalized, is not subject to comprehensive consolidated supervision. Therefore, relationships between the U.S. depository institution and other affiliates may be harder to understand and monitor. To reduce these risks, the U.S. banking agencies (1) work with appropriate non-U.S. supervisors to better understand and monitor the activities of the foreign affiliates and owners; (2) share information, as appropriate, with foreign and domestic bank supervisory agencies; and (3) impose special conditions or obtain special commitments or representations related to an application or an enforcement or other supervisory action, when warranted.

Parallel-owned banking organizations may foster additional management and supervisory risks:

7. References to "foreign bank" or "foreign parallel bank" also include a holding company of the foreign bank and any U.S. or foreign affiliates of the foreign bank. References to "U.S. depository institution" do not include a U.S. depository institution that is controlled by a foreign bank.

8. The term "persons" includes both business entities and natural persons, which may or may not be U.S. citizens.

9. A bank holding company or savings and loan holding company, however, may be a component of a parallel-owned banking organization. This situation may arise when a bank holding company or savings and loan holding company controls the U.S. depository institution, and the holding company, in turn, is controlled by a person or group of persons who also controls a foreign bank.

10. The Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

11. The sharing of a director, by itself, is unlikely to indicate common control of the U.S. and foreign depository institutions.

- Officers and directors of the U.S. depository institution may be unable or unwilling to exercise independent control to ensure that transactions with the foreign parallel bank or affiliates are legitimate and comply with applicable laws and regulations. As a result, the U.S. depository institution may be the conduit or participant in a transaction that violates U.S. law or the laws of a foreign country, or that is designed to prefer a foreign bank or nonbank entity in the group, to the detriment of the U.S. depository institution.
- Money-laundering concerns may be heightened due to the potential lack of arm's-length transactions between the U.S. depository institution and the foreign parallel bank. Specifically, the flow of funds through wires, pouch activity, and correspondent accounts may be subject to less internal scrutiny by the U.S. depository institution than usually is warranted.[12] This risk is greatly increased when the foreign parallel bank is located in an offshore jurisdiction or other jurisdiction that limits exchange of information through bank secrecy laws, especially if the jurisdiction has been designated as a "non-cooperating country or territory" or the jurisdiction or the foreign bank has been found to be of primary money-laundering concern under the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001.
- Securities, custodial, and trust transactions may be preferential to the extent that assets, earnings, and losses are artificially allocated among parallel banks. Similarly, low-quality assets and problem loans can be shifted among parallel banks to manipulate earnings or losses and avoid regulatory scrutiny. Also, if the foreign parallel bank were to begin experiencing financial difficulties, the foreign bank or the common owners might pressure the U.S. depository institution to provide credit support or liquidity to an affiliate in excess of the legal limits of 12 USC 371c and 371c-1.
- The home country of the foreign parallel bank may have insufficient mechanisms or authority to monitor changes in ownership or to ensure arm's-length intercompany transactions between the foreign parallel bank and other members of the group, including the U.S. depository institution, or to monitor concentrations of loans or transactions with third parties that may present safety-and-soundness concerns to the group.
- Capital may be generated artificially through the use of international stock-purchase loans. Such loans can be funded by the U.S. depository institution to the foreign affiliate or to a nonaffiliate with the purpose of supporting a loan back to the foreign affiliate and used to leverage the U.S. depository institution or vice versa. This concern is heightened for parallel-owned banking organizations if the foreign bank is not adequately supervised.
- Political, legal, or economic events in the foreign country may affect the U.S. depository institution. Events in the foreign country, such as the intervention and assumption of control of the foreign parallel bank by its supervisor, may trigger a rapid inflow or outflow of deposits at the U.S. depository institution, thereby affecting liquidity. Foreign events may increase reputational risk to the U.S. depository institution. In addition, these events may adversely affect the foreign bank owner's financial resources and decrease the ability of the foreign bank owner to provide financial support to the U.S. depository institution. Foreign law may change without the U.S. depository institution or the banking agencies becoming aware of the effect of legal changes on the parallel-owned banking organization, including the U.S. depository institution.
- Parallel-owned banking organizations may seek to avoid legal lending limits or limita-

12. On October 28, 2002, the U.S. Department of the Treasury's regulation to implement sections 313 and 319(b) of the USA PATRIOT Act became effective. (See 31 CFR 1010.630 and 1010.670.) The regulation implemented new provisions of the Bank Secrecy Act that relate to foreign correspondent accounts. A covered financial institution (CFI) (a financial institution that is covered by the regulation) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in any country) that is not affiliated with a U.S.-domiciled financial institution or with a foreign bank that maintains a physical presence in the United States or a foreign country and that is supervised by its home-country banking authority. A CFI must take reasonable steps to ensure that a correspondent account of a foreign bank (an account established by a CFI for a foreign bank to receive deposits from, to make payments or other disbursements on behalf of a foreign bank, or to handle other financial transactions related to the foreign bank) is not being used to indirectly provide banking services to foreign shell banks. The regulation includes recordkeeping requirements and required account-termination procedures that are to be used by CFIs having correspondent accounts of foreign banks. See SR-05-9 for a discussion of the PATRIOT Act's requirements for a financial institution's customer identification program. A customer identification program should be part of an institution's overall anti-money-laundering and BSA compliance program. See also the *FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Manual*.

tions imposed by securities or commodities exchanges or clearinghouses on transactions by one counterparty, thereby unduly increasing credit risk and other risks to the banking organizations and others.

To minimize risks, the U.S. banking agencies coordinate the supervision of a parallel-owned banking organization's U.S. operations. The supervisory approach may include unannounced coordinated examinations if more than one regulator has examination authority. Such examinations may be conducted if regulators suspect irregular transactions between parallel-owned banks, such as the shifting of problem assets between the depository institutions. Factors to consider in determining whether to conduct coordinated reviews of an organization's U.S. operations include: (1) intercompany and related transactions; (2) strategy and management of the parallel-owned banking organization; (3) political, legal, or economic events in the foreign country; and (4) compliance with commitments or representations made or conditions imposed in the application process, or conditions pursuant to prior supervisory action.

The U.S. depository institution's board of directors and senior management are expected to be cognizant of the risks associated with being part of a parallel-owned banking structure, especially with respect to diversion of a depository institution's resources, conflicts of interest, and affiliate transactions. The depository institution's internal policies and procedures should provide guidance on how personnel should interact with affiliates. The Federal Reserve and other U.S. banking agencies will expect to have access to such policies, as well as to the results of any audits of compliance with the policies. The agencies will seek an overview of the entire organization, as well as a better understanding of how foreign bank affiliates are supervised. Authorized bank regulatory supervisory staff will work with foreign supervisors to better understand the activities of the foreign affiliates and owners. As appropriate and feasible, and in accordance with applicable law, such authorized staff will share information regarding material developments with foreign and domestic supervisory agencies that have supervisory responsibility over relevant parts of the parallel-owned banking organization.

DOMESTIC AND FOREIGN SUBSIDIARIES

Domestic subsidiaries are any majority-owned companies, other than Edge Act or agreement corporations, domiciled in the United States and its territories and possessions. Foreign subsidiaries are any majority-owned or -controlled companies domiciled in a foreign country or any Edge Act or agreement corporation. Section 211.13 of Regulation K (12 CFR 211.13) requires foreign subsidiaries to maintain effective systems of records, controls, and reports to keep bank management informed of their activities and conditions. In particular, these systems are to provide information on risk assets, exposure to market risk, liquidity management, operations, internal controls, and conformance with management policies. Reports on risk assets must be sufficient enough to allow for an appraisal of credit quality and an assessment of exposure to loss; for that purpose, they must provide full information on the condition of material borrowers. Reports on the operations and controls are to include internal and external audits of the branch or subsidiary.

On-site examinations of foreign subsidiaries are sometimes precluded because of objections voiced by foreign directors, minority shareholders, or local bank supervisors. In addition, secrecy laws in some countries may preclude on-site examinations. When on-site examinations cannot be performed, foreign subsidiary reports submitted according to section 211.13 and reports submitted to foreign banking authorities must serve as the basis for evaluating the bank's investment.

Additionally, Regulation K allows for investments in foreign companies to be made under the general-consent provisions without prior approval of the Board. These investments can be sizable and can pose significant risk to the banking organization. Investments in foreign subsidiaries should be reviewed for compliance with the FRA and investment limitations in Regulation K. (See Regulation K, sections 211.8 and 211.9.)

SIGNIFICANT SUBSIDIARIES

As used in the consolidation instructions for certain regulatory reports (for example, the FR Y-11/FR Y-11S, "Financial Statements of

U.S. Nonbank Subsidiaries of U.S. Holding Companies"), "significant subsidiaries" generally refers to subsidiaries that meet any one of the following tests:

- a majority-owned subsidiary in which the bank's direct and indirect investment and advances represent 5 percent or more of the parent bank's equity capital accounts,
- a majority-owned subsidiary whose gross operating revenues amount to 5 percent or more of the parent bank's gross operating revenues,
- a majority-owned subsidiary whose "income (loss) before income taxes and securities gains or losses" amounts to 5 percent or more of the parent bank's "income (loss) before income taxes and securities gains or losses," or
- a majority-owned subsidiary that is the parent of one or more subsidiaries that, when consolidated, constitute a "significant subsidiary" as defined above.

ASSOCIATED COMPANIES

Associated companies are those in which the bank directly or indirectly owns 20 percent to 50 percent of the outstanding common stock, unless the bank can rebut to the Federal Reserve the presumption of exercising significant influence. However, as noted above, for purposes of section 23A, affiliation is defined by 25 percent share ownership. Because of the absence of direct or indirect control, regulators have no legal authority to conduct full examinations of this type of company. Investments in these companies are generally appraised in the same way as commercial loans, that is, by a credit analysis of the underlying financial information.

CHAIN-BANKING ORGANIZATIONS

Chain-banking organizations exist when an individual (or group of individuals) is a principal in two or more banking institutions, in either banks or BHCs or a combination of both types of institutions. Chain-banking organizations can also exist in savings and loan holding companies (SLHCs). In these systems, the possibility exists that problems in one or more of the entities may adversely affect the safety and soundness of the bank entities because of pressure exerted by their common principal (or principals). Examiners should determine whether the bank is a member of a chain. If so, the extent of its relationship with other links of the chain should be determined, as well as the effects these relationships have on the bank.

REAL ESTATE INVESTMENT TRUSTS AND OTHER RELATED ORGANIZATIONS

Although a bank, its parent holding company, or its nonbank affiliate may not have a direct investment in an "other related organization," the bank may sponsor, advise, or influence the activities of these companies. The most notable examples are real estate investment trusts (REITs) or special-purpose vehicles (SPVs). Transactions between the bank and REITs and between other investment companies may be subject to the limitations in section 23A and Regulation W. In other cases, because of nonownership or a less-than-majority ownership, legal authority to conduct an examination does not exist.

A REIT may be considered an affiliate if it is advised by the member bank or by any subsidiary or affiliate of the member bank. In these cases, transactions between the bank and an affiliated REIT are subject to the requirements of section 23A. Because a REIT frequently carries a name that closely identifies it with its sponsoring bank or BHC, failure of the REIT could have an adverse impact on public confidence in the holding company and its subsidiaries.

The examiner should be aware of all significant transactions between the bank under examination and its related REIT in order to determine conflicts of interest and contingent risks. In several instances, REITs have encountered serious financial problems and have attempted to avoid failure by selling questionable assets to, or swapping these assets with, their bank affiliates. In other instances, because of the adversary relationship, REITs have been encouraged to purchase assets of inferior quality from their related organizations.

HOLDING COMPANIES

As defined in section 2 of the BHC Act of 1956 (12 USC 1841 et seq.), a BHC is any company that directly or indirectly, or acting through one or more other persons, owns, controls, or has power to vote 25 percent or more of any class of voting securities of the bank or company; that controls in any manner the election of a majority of the directors or trustees of the bank or company; or that the Board determines, after notice and opportunity for hearing, directly or indirectly exercises controlling influence over the management or policies of the bank or company.

The Home Owners' Loan Act (HOLA) defines an SLHC as any company that directly or indirectly controls a savings association or that controls any other company that is a savings and loan holding company. In general, a company controls a savings association if one or more persons directly or indirectly owns, controls, or has the power to vote more than 25 percent of the voting shares of the savings association, or controls in any manner the election of a majority of the directors of the savings association.

A parent holding company is considered an affiliate when the holding company controls the insured depository institution (IDI) in a manner consistent with the definition of control in section 23A of the FRA. Section 23A exempts from the quantitative and collateral requirements of the law all transactions (except for the purchase of low-quality assets) between "sister" IDIs (IDIs with 80 percent or more common ownership) by a company. A low-quality asset is any asset (1) classified "substandard," "doubtful," or "loss," or treated as "special mentioned" or "other transfer risk problems" in the most recent federal or state examination or inspection report; (2) on nonaccrual status; (3) with principal or interest payments more than 30 days past due; (4) whose terms have been renegotiated or compromised due to the deteriorated financial condition of the borrower; or (5) acquired through foreclosure, repossession, or otherwise in satisfaction of a debt previously contracted, if the asset has not yet been reviewed in an examination or inspection.

Under the BHC Act, the Federal Reserve has authority to inspect BHCs and their nonbank subsidiaries.[13] The Federal Reserve requires periodic inspections of all BHCs, the frequency of which is based on the size, complexity, and condition of the organization. If a BHC is inspected at the same time as the examination of its state member bank subsidiaries, the examiner at the bank should collaborate closely with inspection personnel on those holding company issues that directly affect the condition of the bank. When the BHC inspection is not conducted simultaneously with the examination, the bank examiner should closely review the most recent report of inspection and may also need to consult the FR Y-series of reports regularly submitted to the Federal Reserve System by BHCs.

Many depository institutions are owned by holding companies. To understand the effects of the holding company structure on the subsidiary IDI, the examiner should evaluate the overall financial support provided by the parent company, quality of supervision and centralized functions provided, and appropriateness of intercompany transactions. Since financial and managerial issues at the holding company and subsidiary IDI levels are so closely connected, it is strongly recommended that a holding company inspection and its respective bank examination(s) be conducted at the same time or shortly after the examination of the lead bank. A combined examination/inspection report, as discussed in SR 94-46, is available to facilitate this coordination when the lead subsidiary is a state member bank.

Financial Support

The holding company structure can provide its subsidiary IDI with strong financial support because of its greater ability to attract and shift funds to less capital-intensive areas and to enter markets in a wider geographic area than would otherwise be possible. Financial support may take the form of capital (equity or debt) or funding of loans and investments. In general, the lower the parent BHC's leverage, the more it is able to serve as a source of financial strength to its IDI subsidiaries. This is because less cash flow will be required from the IDIs for debt servicing and the parent has more borrowing capacity, which could be used to provide funds to the IDI. When the financial condition of the holding company or its nonbanking subsidiaries is unsound, the operations of its subsidiary IDI can be adversely affected. To service its debt or provide support to another subsidiary that is experiencing financial difficulty, the holding

13. Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) transfers to the Board of Governors of the Federal Reserve System the supervisory functions of the Office of Thrift Supervision related to savings and loan holding companies (SLHCs) and their nondepository subsidiaries beginning on July 21, 2011.

company may involve its IDI subsidiary in the following imprudent actions:

- engaging in high-risk investments to obtain increased yields,
- purchasing or swapping its high-quality assets for the parent's or other affiliate's lower-quality assets,
- entering into intercompany transactions that are detrimental because of inordinately high fees or inadequate or unnecessary services,
- paying excessive dividends, or
- making improper tax payments or unfavorably altering its tax situation.

Even when the holding company's structure is financially sound, the holding company's ability to sell short- or long-term debt and to pass the proceeds down to its IDI subsidiary in the form of equity capital may still present problems. This procedure is frequently referred to as "double leveraging," the amount of the equity investment in the bank subsidiary that is financed by debt. Problems may arise when the holding company must service its debt out of dividends from the subsidiary, and the subsidiary, if it encounters an earnings problem or is prevented by regulatory agreement or action, may not be able to pass dividends up to its parent.

Another potential problem may develop when the holding company sells its commercial paper and funds its subsidiary's loans with those proceeds. This may cause a liquidity problem if the maturities of the commercial paper sold and loans funded are not matched appropriately and if the volume of such funding is large in relation to the subsidiary's overall operations.

The Board's Regulation Y provides that a BHC shall serve as a source of financial and managerial strength to their subsidiary banks.[14] Regulation Y reiterates a general policy that has been expressed on numerous occasions in accordance with authority that is provided under the BHC Act and the enforcement provisions of the FDI Act. The FDI Act also requires SLHCs to act as a source of strength to their depository institution subsidiaries. See section 38A of the FDI Act and section 616(d) of the Dodd-Frank Act.

14. 12 CFR 225.4 (a)(1).

Holding Company Oversight of Subsidiaries

BHCs use a variety of methods to supervise their bank subsidiaries, including

- having holding company senior officers serve as directors on the bank's board;
- establishing reporting lines from senior bank management to corporate staff;
- formulating or providing input into key policies; and
- establishing management information systems, including internal audit and loan review.

As part of the evaluation of bank management, the examiner should be aware of these various control mechanisms and determine whether they are beneficial to the bank. Examiners should keep in mind that, even in a holding company organization, the directors and senior management of the bank are ultimately responsible for operating it in a safe and sound manner.

In addition, many bank functions (investment management, asset/liability management, human resources, operations, internal audit, and loan review) may be performed on behalf of the bank by its parent BHC or by a nonbank affiliate. These functions are reviewed at inspections of the holding company. Examiners at the bank should be aware of the evaluation of these functions by inspection personnel, either at a concurrent inspection or in the report of a prior inspection. In addition, a review of these same issues at the level of the subsidiary bank is useful to determine compliance with corporate policies, corroborate inspection findings, and identify any inappropriate transactions that may have been overlooked in the more general, top-down review at the parent level.

FINANCIAL HOLDING COMPANIES

Section 4(k) of the BHC Act authorizes affiliations among banks, securities firms, insurance firms, and other financial companies. It provides for the formation of financial holding companies (FHCs) and allows a BHC or foreign bank that qualifies as an FHC to engage in a broad range of activities that are (1) defined by the GLB Act to be financial in nature or incidental to a financial activity or (2) determined by the Board, in consultation with the secretary of the Treasury, to be financial in nature or incidental to a financial activity or that are determined by the Board to be complementary to a financial activity, which would not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally.

Certain conditions must be met for a BHC, SLHC, or a foreign bank to be deemed an FHC and to engage in the expanded activities. BHCs that do not qualify as FHCs are limited to engaging in those nonbanking activities that are permissible under section 4(c)(8) of the BHC Act. Section 4(k) of the BHC Act authorizes an FHC to engage in designated financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities.

Supervisory Oversight

The Federal Reserve has supervisory oversight authority and responsibility for SLHCs and BHCs that operate as FHCs and for SLHCs and BHCs that are not FHCs. The GLB Act sets parameters for operating relationships between the Federal Reserve and other regulators. The GLB Act differentiates between the Federal Reserve's relations with (1) depository institution regulators and (2) functional regulators, which include insurance, securities, and commodities regulators. The Federal Reserve's relationships with functional regulators will, in practice, depend on the extent to which an FHC is engaged in functionally regulated activities; those relationships will also be influenced by existing working arrangements between the Board and the functional regulator.

The Federal Reserve's supervisory oversight role is that of an umbrella supervisor concentrating on a consolidated or group-wide analysis of an organization. Umbrella supervision is not an extension of more traditional bank-like supervision throughout an FHC. The FHC framework is consistent with and incorporates principles that are well established for BHCs. The FHC supervisory policy focuses on addressing supervisory practice for and relationships with FHCs, particularly those that are engaged in securities or insurance activities. (See SR 00-13 and SR 14-9).

The Federal Reserve is responsible for the consolidated supervision of FHCs. The Federal Reserve thus assesses the holding company on a consolidated or group-wide basis. The objective is to ensure that the holding company does not threaten the viability of its depository institution subsidiaries. Depository institution subsidiaries of FHCs are supervised by their appropriate primary bank or thrift supervisor (federal and state). However, the GLB Act did not change the Federal Reserve's role as the federal BHC supervisor.

Nonbank (or nonthrift) subsidiaries engaged in securities, commodities, or insurance activities are to be supervised by their appropriate functional regulators. Examples of these functionally regulated subsidiaries include a broker, dealer, investment adviser, and investment company registered with and regulated by the Securities and Exchange Commission (SEC) (or, in the case of an investment adviser, registered with any state); an insurance company or insurance agent subject to supervision by a state insurance regulator; and a nonbank subsidiary engaged in activities regulated by the Commodity Futures Trading Commission (CFTC).

As the umbrella supervisor, the Federal Reserve will seek to determine that FHCs are operated in a safe and sound manner so that their financial condition does not threaten the viability of affiliated depository institutions. Oversight of FHCs (particularly those engaged in a broad range of financial activities) at the consolidated level is important because the risks associated with an FHC's activities can cut across legal entities and business lines. The purpose of FHC supervision is to identify and evaluate, on a consolidated or group-wide basis, the significant risks that exist in a diversified holding company to assess how these risks might affect the safety and soundness of depository institution subsidiaries.

The Federal Reserve's focus will be on the financial strength and stability of FHCs, their consolidated risk-management processes, and overall capital adequacy. The Federal Reserve will review and assess internal policies, reports, and procedures, as well as the effectiveness of the FHC consolidated risk-management process. The appropriate bank, thrift, or functional regulator will continue to have primary responsibility for evaluating risks, hedging, and risk management at the legal-entity level for the entity or entities that it supervises.

Permissible Activities

Permissible activities for FHCs include any activity that the Board determined to be closely related to banking under section 4(c)(8) of the BHC Act by regulation that was in effect prior to November 12, 1999, or by order that was in effect on November 12, 1999. This includes the long-standing "laundry list" of nonbanking activities for BHCs. (See section 225.28(b) of Regulation Y.) Section 225.86(a)(2) of Regulation Y lists the nonbanking activities approved for BHCs by Board order as of November 12, 1999.[15]

Section 4(k)(4)(G) of the BHC Act also defines "financial in nature" as any activity (1) in which a BHC may engage outside the United States and (2) that the Board has determined, by regulation or interpretations issued under section (4)(c)(13) of the BHC Act that were in effect on November 11, 1999, to be usual in conducting banking or other financial services abroad. Section 225.86(b) of Regulation Y lists three activities that the Board has found to be usual in connection with the transaction of banking or other financial operations abroad.[16] The activities are (1) providing management consulting services; (2) operating a travel agency; and (3) organizing, sponsoring, and managing a mutual fund. The conduct of each activity has certain prescribed limitations. Management consulting services must be advisory and not allow the FHC to control the person to whom the services are provided. These services, however, may be offered to any person on nonfinancial matters. An FHC may also operate a travel agency in connection with financial services offered by the FHC or others. Finally, a mutual fund organized, sponsored, or managed by an FHC may not exercise managerial control over the companies in which the fund invests, and the FHC must reduce its ownership of the fund, if any, to less than 25 percent of the equity of the fund within one year of sponsoring the fund (or within such additional period as the Board permits).

The activities that a BHC is authorized to engage in outside the United States under section 211.10 of Regulation K have been either (1) authorized for FHCs in a broader form by the GLB Act (for example, underwriting, distributing, and dealing in securities and underwriting various types of insurance) or (2) authorized in the same or a broader form in Regulation Y (for example, data processing activities; real and personal property leasing; and acting as agent, broker, or adviser in leasing property). Section 4(k)(4)(G) of the BHC Act and section 225.86 of Regulation Y only authorize FHCs to engage in the activities that are listed in section 211.10 of Regulation K, as interpreted by the Board. The Board has also approved activities found in individual orders issued under section 4(c)(13) of the BHC Act. Section 4(k)(4)(G) and Regulation Y do not authorize an FHC to engage in activities that the Board authorized a BHC to provide in individual orders issued under section 4(c)(13) of the BHC Act.

The remaining activities authorized by section 4(k)(4) of the BHC Act are those that are defined to be "financial in nature" under section 4(k)(4)(A) through (E), (H), and (I). (See section 225.86(c) of Regulation Y.) These activities include issuing annuity products and acting as principal, agent, or broker for purposes of insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death. Permissible insurance activities as principal include reinsuring insurance products. An FHC acting under section 4(k)(4) of the BHC Act may conduct insurance activities without regard to the restrictions on the insurance activities imposed on BHCs under section 4(c)(8). (See section 3905.0 of the *Bank Holding Company Supervision Manual* for more information pertaining to the activities of FHCs.)

INTERCOMPANY TRANSACTIONS

As with the supervision of subsidiaries, intercompany transactions should be reviewed at both the parent level during inspections and at the subsidiary-bank level during examinations. The transactions should comply with sections 23A and 23B of the FRA, Regulation W, and should not otherwise adversely affect the financial condition of the bank.

15. Section 20 company activities are not included in this list. Section 4(k)(4)(E) of the BHC Act authorizes FHCs to engage in securities underwriting, dealing, and market-making activities in a broader form than was previously authorized by Board order.

16. See section 211.10 of Regulation K (12 CFR 211.10).

Intercompany Tax Payments

SR letter 98-38, "Interagency Policy Statement on Tax Allocation in a Holding Company Structure," provides guidance to banking organizations and savings associations regarding the allocation and payment of taxes among a holding company and its subsidiaries. A holding company and its depository institution subsidiaries will often file a consolidated group income tax return. However, each depository institution is viewed as, and reports as, a separate legal and accounting entity for regulatory purposes. Accordingly, each depository institution's applicable income taxes, reflecting either an expense or benefit, should be recorded as if the institution had filed on a separate entity basis. Furthermore, the amount and timing of payments or refunds should be no less favorable to the subsidiary than if it were a separate taxpayer. The 2014 addendum to the policy statement provides that the holding company is acting as an agent on behalf of its IDIs when it relates to tax allocation within the company. See 79 *Fed. Reg.* 35338 (June 19, 2014) and SR 14-6.

Management and Other Fees

IDIs often obtain goods and services from the parent holding company or an affiliated nonbank subsidiary. These arrangements may benefit the IDI, since the supplier may offer lower costs because of economies of scale, such as volume dealing. Furthermore, IDIs may be able to purchase a package of services that otherwise might not be available. However, because of the relationship between the IDI and the supplier, examiners should ensure that the fees being paid represent reasonable reimbursement for goods and services received. Fees paid by the IDI to the parent or nonbank affiliates should have a direct relationship to, and be based solely on, the fair value of goods and services provided. Fees should compensate the affiliated supplier only for providing goods and services that meet the legitimate needs of the IDI.

IDIs should retain satisfactory records that substantiate the value of goods and services received, their benefit to the IDI, and their cost efficiencies. There are no other minimum requirements for records, but an examiner should be able to review the records maintained and determine that fees represent reasonable payment. In general, the supplier will decide on the amount to be charged by the comparative free-market value of the services.

When the servicer incurs overhead expenses, recovery of those costs is acceptable to the extent they represent a legitimate and integral part of the service rendered. Overhead includes salaries and wages, occupancy expenses, utilities, payroll taxes, supplies, and advertising. Debt-service requirements of holding companies, shareholders, or other related organizations are not legitimate overhead expenses for a subsidiary bank.

Generally, the payment of excessive fees is considered an unsafe and unsound practice and is a violation of section 23B of the FRA and the Board's Regulation W. When fees are not justified, appear excessive, do not serve legitimate needs, or are otherwise abusive, the examiner should inform the board of directors through appropriate criticism in the report of examination.

Dividends

Dividends represent a highly visible cash outflow by banks. If the dividend-payout ratio exceeds the level at which the growth of retained earnings can keep pace with the growth of assets, the bank's capital ratios will deteriorate. Examiners should evaluate the appropriateness of dividends relative to the bank's financial condition, prospects, and asset-growth forecast.

Purchases or Swaps of Assets

Asset purchases or swaps between IDIs and their affiliates create the potential for abuse. Regulatory concern focuses on the fairness of such asset transactions, their financial impact, and timing. Fairness and financial considerations include the quality and collectibility of such assets and liquidity effects. Asset exchanges may be a mechanism to avoid regulations designed to protect subsidiary banks from becoming overburdened with nonearning assets. Most asset purchases by an IDI from an affiliate are subject to sections 23A and 23B of the FRA.

Compensating Balances

A subsidiary bank may be required to maintain excess balances at a correspondent bank that lends to other parts of the holding company organization, possibly to the detriment of the bank. The subsidiary bank may be foregoing earnings on such excess funds, which may adversely affect its financial condition.

Split-Dollar Life Insurance

Split-dollar life insurance is a type of life insurance in which the purchaser of the policy pays at least part of the insurance premiums and is entitled to only a portion of the cash surrender value, or death benefit, or both. In some circumstances, when the subsidiary bank pays all or substantially all of the insurance premiums, an unsecured extension of credit from the bank to its parent holding company generally results because the bank has paid the holding company's portion of the premium, and the bank will not be fully reimbursed until later. In other arrangements, when the parent uses the insurance policy as collateral for loans from the subsidiary bank, the loan may not meet the collateral requirements of section 23A or Regulation W. In addition, split-dollar arrangements may not comply with section 23B or Regulation W if the return to the bank is not commensurate with the size and nature of its financial commitment. Finally, split-dollar arrangements may be considered unsafe and unsound, which could be the case if the bank is paying the entire premium but is not the beneficiary of the policy, or if it receives less than the entire proceeds of the policy. This type of transaction may also result in a violation of the Board's Regulation W. (See SR 93-37, "Split-Dollar Life Insurance.")

Other Transactions with Affiliates

Checking accounts of the parent or nonbank subsidiaries at subsidiary banks present the potential for overdrafts, which are regarded as unsecured extensions of credit to an affiliate by the subsidiary bank, and are in violation of section 23A of the FRA. In general, a subsidiary bank should be adequately compensated for its services or for the use of its facilities and personnel by other parts of the holding company organization. In addition, a subsidiary bank should not pay for expenses for which it does not receive a benefit (for example, the formation expenses of a BHC or SLHC).

Situations sometimes arise in which more than one legal entity in a banking organization shares offices or staff. In certain cases, it can be hard to determine whether a legal entity is operating within the scope of its permissible activities. In addition, a counterparty may be unclear as to which legal entity an employee is representing. Finally, there may be expense-allocation problems and, thus, issues pertaining to sections 23A and 23B of the FRA or Regulation W. Examiners should be aware of these concerns and make sure that institutions have the proper records and internal controls to ensure an adequate separation of legal entities. (See SR 95-34 "Sharing of Facilities and Staff by Banking Organizations.")

EVALUATION OF INVESTMENTS IN AND LOANS TO BANK-RELATED ORGANIZATIONS

To properly evaluate affiliates and other bank-related organizations[17] relative to the overall condition of the bank, the examiner must

- know the applicable laws and regulations that define and establish limitations with respect to investments in, and extensions of credit to, affiliates and
- analyze thoroughly the propriety of the related organizations' carrying value, the nature of the relationships between the bank and its related organizations, and the effect of such relationships on the affairs and soundness of the bank.

The propriety of the carrying value of a bank's investment in any related organization is determined by evaluating the balance sheet and income statement of the company in which the bank has the investment. At times, this may not

17. Information about related organizations and interlocking directorates and officers can be obtained from the bank holding company form FR Y-6 and SEC form 10-K, if applicable, or from other required domestic and foreign regulatory reports. Further information on business interests of directors and principal officers of the bank can be obtained by reviewing information maintained by the bank in accordance with the Board's Regulation O.

seem important in relation to the overall condition of the bank because the amount invested may be small relative to the bank's capital. It may appear that a cursory appraisal of the company's assets would therefore be sufficient. However, the opposite is often true. Even though a bank's investment in a subsidiary or associated company is relatively small, the underlying fiduciary or compliance obligations may be substantial and may greatly exceed the total amount of the reported investment. If the subsidiary experiences large losses, the bank may have to recapitalize the subsidiary by injecting much more than its original investment to protect unaffiliated creditors of the subsidiary or protect its own reputation.

When examining and evaluating the bank's investment in and loans to related organizations, classified assets held by such companies should first be related to the capital structure of the company and then be used as a basis for classifying the bank's investment in and loans to that company.

One problem that examiners may encounter when they attempt to evaluate the assets of some subsidiaries and associated companies is inadequate on-premises information. This may be especially true of foreign investments and associated companies in which the bank has less than a majority interest. In those instances, the examiner should request that adequate information be obtained during the examination and should establish agreed-on standards for that information in the future. The examiner should insist that the organization have adequate supporting information readily obtainable or available in the bank and that the information be of sufficient quality to allow for an informed evaluation of the investment. Bank management, as well as regulatory authorities, must be adequately informed of the condition of the companies in which the bank has an investment. For subsidiary companies, it is necessary that bank representatives be a party to policy decisions, have some on-premises control of the company (such as board representation), and have audit authority. In the case of an associated company, the bank should participate in company affairs to the extent practicable. Information documenting the nature, direction, and current financial status of all such companies should be maintained at the bank's head office or maintained regionally for global companies. Full audits by reputable certified public accountants are often used to provide much of this information.

For foreign subsidiaries, in addition to the audited financial information prepared for management, the bank should have on file the following:

- reports prepared according to the Board's Regulation K;
- reports prepared for foreign regulatory authorities;
- information on the country's regulatory structure, current economic conditions, anticipated relaxation or strengthening of capital or exchange controls, and fiscal policy, political goals, and a determination as to the potential risk of expropriation; and
- adequate information to review compliance with the investment provisions of Regulation K. (For each investment, information should be provided on the type of investment (equity, binding commitments, capital contributions, subordinated debt), dollar amount of the investment, percentage ownership, activities conducted by the company, legal authority for such activities, and whether the investment was made under Regulation K's general-consent, prior-notice, or specific-consent procedures. With respect to investments made under the general-consent authority, information also must be maintained that demonstrates compliance with the various limits set out in section 211.9 of Regulation K. (See Regulation K, sections 211.8 and 211.9.)

Examination procedures are available on the Examination Documentation (ED) modules page on the Board's website. See the following ED module for examination procedures on this topic:

- Related Organizations

INTERAGENCY POLICY ON BANKS AND THRIFTS PROVIDING FINANCIAL SUPPORT TO FUNDS ADVISED BY THE BANKING ORGANIZATION OR ITS AFFILIATES

On January 5, 2004, the federal banking agencies[1] (the agencies) issued an interagency policy statement to alert banking organizations, including their boards of directors and senior management, of the safety-and-soundness implications of, and the legal impediments to, a bank providing financial support to investment funds[2] advised by the bank, its subsidiaries, or affiliates (affiliated investment funds). A banking organization's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the associated risks are not effectively controlled. (See SR-04-1.)

Banks are under no statutory requirement to provide financial support to the funds they advise; however, circumstances may motivate banks to do so for reasons of reputation risk and liability mitigation. This type of support by banking organizations to funds they advise has included credit extensions, cash infusions, asset purchases, and the acquisition of fund shares. In very limited circumstances, certain arrangements between banks and the funds they advise have been expressly determined to be legally permissible and safe and sound when properly conducted and managed. However, the agencies are concerned about other occasions when emergency liquidity needs may prompt banks to support their advised funds in ways that raise prudential and legal concerns. Federal laws and regulations place significant restrictions on transactions between banks and their advised funds. In particular, sections 23A and 23B of the Federal Reserve Act and the Board's Regulation W (12 CFR 223) place quantitative limits and collateral and market-terms requirements on many transactions between a bank and certain of its advised funds.

1. The Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS). Title III of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd Frank Act) abolished the OTS, which had been responsible for regulating state and federal savings associations and their holding companies. See 12 U.S.C 5413 (Dodd-Frank Act 313). The OTS's functions and powers were transferred to the OCC, FDIC, and the Board. The Board acquired regulatory and rulemaking authority over savings and loan holding companies. See 12 U.S.C. 5412 (Dodd-Frank Act 312). The OCC acquired supervisory and rulemaking authority over federal savings associations. The FDIC acquired supervisory and rulemaking authority over state-chartered savings associations.

2. Bank-advised investment funds include mutual funds, alternative strategy funds, collective investment funds, and other funds where the bank, its subsidiaries, or affiliates is the investment adviser and receives a fee for its investment advice. For purposes of the guidance, "banks" includes banks and savings associations.

Interagency Policy

To avoid engaging in unsafe and unsound banking practices, banks should adopt appropriate policies and procedures governing routine or emergency transactions with bank-advised investment funds. Such policies and procedures should be designed to ensure that the bank will *not* (1) inappropriately place its resources and reputation at risk for the benefit of the funds' investors and creditors; (2) violate the limits and requirements contained in sections 23A and 23B of the Federal Reserve Act and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or (3) create an expectation that the bank will prop up the advised fund. Further, the agencies expect banking organizations to maintain appropriate controls over investment advisory activities that include:

- Establishing alternative sources of emergency support from the parent holding company, nonbank affiliates, or external third parties prior to seeking support from the bank.
- Instituting effective policies and procedures for identifying potential circumstances triggering the need for financial support and the process for obtaining such support. In the limited instances that the bank provides financial support, the bank's procedures should include an oversight process that requires formal approval from the bank's board of directors, or an appropriate board-designated committee, independent of the investment advisory function. The bank's audit committee also should review the transaction to

ensure that appropriate policies and procedures were followed.
- Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by the organization's investment advisory activities. Risk controls should include establishing appropriate risk limits, liquidity planning, performance measurement systems, stress testing, compliance reviews, and management reporting to mitigate the need for significant bank support.
- Implementing policies and procedures that ensure that the bank is in compliance with existing disclosure and advertising requirements to clearly differentiate the investments in advised funds from obligations of the bank or insured deposits.
- Ensuring proper regulatory reporting of contingent liabilities arising out of its investment advisory activities in the banking organization's published financial statements in accordance with Accounting Standards Codification subtopic 450-20, Contingencies: Loss Contingencies, and fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities in accordance with the instructions for completing Call Report Schedule RC-T (Fiduciary and Related Services).

Notification of a Banking Organization's Primary Federal Regulator

Because of the potential risks posed by the provision of financial support to advised funds, bank management should notify and consult with its appropriate federal banking agency prior to the bank providing material financial support to its advised funds. The appropriate federal banking agency will closely scrutinize the circumstances surrounding the transaction and will address situations that raise supervisory concerns.

1. To determine if the bank provides support to an advised fund and, if so, the type of support that is being provided.
2. If the bank is providing support to an advised fund, to ascertain whether the type of support raises prudential (safety-and-soundness) or legal concerns, such as noncompliance with sections 23A and 23B of the Federal Reserve Act, and with Regulation W.
3. To determine whether the bank has adopted appropriate policies and procedures governing routine or emergency transactions with funds that it advises.
4. To find out if the bank has established appropriate controls over investment advisory activities.
5. If a bank has provided material financial support to an advised fund, to determine if the bank notified its primary federal regulator before engaging in the activity.

1. Determine if the bank has inappropriately placed its resources at risk for the benefit of an affiliated investment fund's investors and creditors.
2. Ascertain whether the bank's advisory services to investment funds pose material risks to the bank's liquidity, earnings, and capital.
3. Determine if the bank provides support to an investment fund and if that support violates the limits and requirements of sections 23A and 23B of the Federal Reserve Act, and Regulation W; other applicable legal requirements; or any special supervisory condition imposed by the bank's primary federal supervisory agency.
4. Find out if the bank has given any form of assurances or expectations that it will provide financial or other support to an advised fund.
5. Ascertain whether the bank has established appropriate controls over investment advisory activities, such as:
   a. Establishing alternative sources of emergency support that can be made available to an advised fund from the parent holding company, nonbank affiliates, or external third parties before the fund seeks financial support from the bank.
   b. Instituting effective policies and procedures to—
      - identify potential circumstances that would trigger the need for financial support by an affiliated fund, and establish the process for obtaining that support;
      - ensure that the bank is in compliance with existing disclosure and advertising requirements that clearly differentiate the investments in advised funds from the bank's other obligations or federally insured deposits; and
      - avoid unsafe and unsound banking practices by initiating procedures that govern routine or emergency transactions with bank-advised investment funds.
   c. Implementing an effective risk-management system for controlling and monitoring risks posed to the bank by its investment advisory activities.
   d. Ensuring the bank's proper reporting, in its financial statements, of contingent liabilities that arise out of its investment advisory activities.
6. Determine if the bank notified and consulted with the appropriate supervising Federal Reserve Bank before providing financial support to an affiliated investment fund.

Review the bank's internal controls, policies, practices, and procedures concerning investment funds that it advises. When performing that task, conduct examination reviews and procedures to answer the following questions:

1. Has the bank—
   a. inappropriately placed its financial resources or reputation at risk for the benefit of affiliated investment funds' investors and creditors?
   b. violated the limits and requirements in sections 23A and 23B of the Federal Reserve Act and in Regulation W, with regard to its transactions with advised investment funds?
   c. created any expectation that the bank will prop up an advised fund?
2. Do the bank's advisory services pose material risks to its liquidity, earnings, and capital?
3. Does the bank encourage its advised investment funds to establish alternative sources of financial support so that the funds can avoid seeking support from the bank itself?
4. Has the bank provided support to the funds it advises, such as with extensions of credit, cash infusions, asset purchases, acquisition of fund shares, or any other type of financial support?
5. Has the bank implemented and maintained an effective risk-management system for controlling and monitoring the risks posed to the bank by its investment advisory activities?
6. Did the bank's board of directors adopt appropriate policies and procedures to avoid engaging in unsafe and unsound banking practices with respect to routine or emergency transactions with bank-advised investment funds?
7. Has the bank's management properly reported contingencies arising out of its investment advisory activities, in accordance with Accounting Standards Codification subtopic 450-20, Contingencies: Loss Contingencies, and also any fiduciary settlements, surcharges, and other losses arising out of its investment advisory activities, in accordance with the instructions of the bank Call Report Schedule RC-T (Fiduciary and Related Services)?
8. Has the bank's management notified and consulted with its appropriate supervising Federal Reserve Bank before providing material financial support to advised funds?

INTRODUCTION

Among other things, section 106 of the Bank Holding Company Act Amendments of 1970 (section 106) prohibits a bank from conditioning the availability or price of one product on a requirement that the customer also obtain another product from the bank or an affiliate of the bank.[1] The statute is intended to prevent banks from using their ability to offer bank products in a coercive manner to gain a competitive advantage in markets for other products and services.[2] Tying arrangements that are prohibited by section 106 may be addressed by the bank's appropriate federal banking agency through an enforcement action, by the Department of Justice through a request for an injunction, or by a customer or other person injured by the tying arrangement through a request for an injunction or a legal action against the bank for damages.[3]

Although section 106 prohibits banks from imposing certain types of tying arrangements on their customers, the statute also expressly permits banks to engage in other forms of tying and authorizes the Board to grant additional exceptions to the statute's prohibitions by regulation or order.

PROHIBITIONS UNDER SECTION 106

Section 106 prohibits a bank from extending credit, leasing or selling property, furnishing any service, or fixing or varying the consideration for any of the foregoing on the condition or requirement that a customer

- obtain some additional credit, property, or service from the bank or its affiliates other than a loan, discount, deposit, or trust service;
- provide some additional credit, property, or service to the bank or its affiliates, other than those related to and usually provided in connection with a loan, discount, deposit, or trust service; or
- not obtain some additional credit, property, or service from a competitor of the bank or of an affiliate of the bank unless the condition is reasonably imposed in a credit transaction to assure the soundness of the credit.[4]

The most common types of tying arrangements are those where a bank product or consideration for a bank product to a customer is conditioned upon the customer obtaining another product from the bank or an affiliate. There are two elements necessary to establish an impermissible tying arrangement under these circumstances: (1) the arrangement must involve two or more separate products and (2) the customer is, in fact, required to buy a tied product in order to get a tying product.

APPLICABILITY OF SECTION 106

Section 106 applies only to tying arrangements that are imposed by a bank, whether or not they are subsidiaries of holding companies. The statute does not apply to tying arrangements imposed by affiliates of the bank. However, an examination of the facts and circumstances of a tying arrangement imposed by a bank affiliate that involves a bank product could reveal that the arrangement essentially is a tying arrangement set forth by the bank, but structured to appear as though it is required by the bank affiliate. These arrangements may constitute prohibited tying arrangements.

Section 106 specifically allows a bank to engage in a tying arrangement if the tied product is a "loan, discount, deposit, or trust service" (a "traditional bank product" provided to a customer).[5] The Board has not clarified the scope of this exception.

A parallel provision, codified in section 5(q) of the Home Owners' Loan Act of 1933, applies to savings associations and is also administered by the Board.[6]

1. 12 U.S.C. 1972. Although part of the Bank Holding Company Act Amendments of 1970, section 106 applies to a bank whether or not the bank is owned or controlled by a bank holding company.
2. Banks and their affiliates, including nonbank affiliates, are also subject to the tying restrictions contained in the federal antitrust laws (the Sherman and Clayton Acts). 15 U.S.C. 1 et seq.; 15 U.S.C. 12 et seq.
3. 12 U.S.C. 1972, 1973, 1975, and 1976.
4. 12 U.S.C. 1972(1).
5. 12 U.S.C. 1972(1)(A). Products or services in the form of a "loan, discount, deposit, or trust service" are considered to be traditional bank products.
6. 12 U.S.C. 1464(q).

EXCEPTIONS TO SECTION 106

Section 106 expressly permits a bank to condition the availability or price of a product on a requirement that the customer also obtain a loan, discount, deposit or trust service from the bank. The statute also expressly permits a bank to condition the availability or price of a product on a requirement that the customer provide the bank with some additional product that is related to and usually provided in connection with a loan, discount, deposit, or trust service. Mixed-product arrangements—or arrangements whereby bank customers can receive a discount if they choose several products among a larger menu of products—may or may not violate section 106 depending on the facts and circumstances.

In addition to the statutory exceptions set forth in section 106, additional regulatory exceptions can be found in the Board's Regulation Y (12 CFR 225.7). These exceptions include (1) situations where the tied product is a traditional bank product offered by an affiliate of the bank, (2) combined-balance discount packages, and (3) bank transactions with foreign persons.

The Board is also authorized, in consultation with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation, to grant additional exceptions to the statute's prohibitions by regulation or order.

INTERNAL CONTROLS TO PROMOTE COMPLIANCE WITH PROHIBITIONS OF SECTION 106

Banks should have policies, procedures and systems in place that are reasonably designed to promote bank compliance with the tying prohibitions of section 106. The types of policies, procedures, and systems appropriate for a particular bank depend on the bank's size, and the nature, scope, and complexity of its activities. Banks should review and update their policies, procedures, and systems periodically to ensure that they reflect any changes in the nature, scope, or complexity of their activities or applicable statutes, regulations, or supervisory guidance.

Banks should also ensure that appropriate bank personnel receive education and training concerning the provisions of section 106. A bank's internal audit function should periodically review and test its tying policies, procedures, and systems in order to confirm that they are working effectively and in the manner intended.

SUPERVISORY CONSIDERATIONS

Federal Reserve examiners review and evaluate a bank's policies and procedures related to tying arrangements.[7] Depending on the facts and circumstances, it may be appropriate to assess compliance with section 106 at the holding company or the state member bank. Examiners should focus on the holding company's responsibility to oversee and safeguard against prohibited tying arrangements by its bank subsidiaries and affiliates. In addition, examiners may conduct more targeted examinations of the marketing programs, training materials, internal reports and internal tying investigations of a bank. Examiners should be aware that the principal objective of section 106 is to eliminate any potential for "arm twisting" customers into buying some other product to get the product they desire. In assessing tying arrangements, examiners should focus their review on the bank's policies, procedures, and internal controls as well as training and audit programs covering compliance with section 106.

As part of this supervisory review, examiners should consider whether tying arrangement policies and procedures have been updated to reflect changes in products and services. Effective policies may contain examples of impermissible practices relevant to the product lines and procedures for employees to follow if questions arise concerning the application of the tying prohibitions.

Examiners should assess whether bank management has established and reviewed key risk management practices to eliminate impermissible tying arrangements when offering customers multiple products or services. For instance, effective training programs raise bank staff's awareness of the prohibitions against tying arrangements. Examiners should determine whether a bank has adopted adequate training programs for employees and whether the training material is appropriately updated. Examiners also should ascertain whether bank management appropri-

7. Section 3500 of the *Bank Holding Company Supervision Manual* provides detailed examination objectives and procedures related to section 106.

ately responds to questions from bank staff about tying.

Examiners should assess the adequacy of the bank's audit and compliance programs related to tying arrangements. If the audit program focused on tying arrangements is infrequent or inadequate, examiners may consider reviewing a sample of pertinent extensions of credit (for example, loans, lines of credit, and letters of credit) that may be susceptible to improper tying arrangements. Examiners should

- review pertinent extensions of credit (for example, loans, lines of credit, and letters of credit) to borrowers whose credit facilities or services may be susceptible to tying arrangements imposed by the bank or company in violation of section 106 or the Board's regulations;
- monitor incentives that may encourage tying by bank employees, such as commission structures and fee-splitting arrangements between departments; and
- respond to any customer allegations of prohibited tying arrangements.

The determination of whether a violation of section 106 has occurred often requires a careful review of the specific facts and circumstances associated with the relevant transaction between the bank and the customer. If there is an apparent violation of law at the bank, examiners generally should communicate the findings in the report of examination or supervisory letter. Examiners should

- name the applicable law (Section 106 of the Bank Holding Company Act Amendments of 1970 (12 U.S.C. 1972)) or regulation (Regulation Y, 12 CFR 225.7);
- provide a brief description of the scope of the relevant law;
- describe the requirements of the regulation or statute;
- note how or why the violation occurred; and
- describe any plans or recommendations for corrective action.

7000—INTERNATIONAL

Generally, the basic objectives and procedures used for the examination and verification of international operations are similar to those used for other domestic bank functions. However, some procedures are modified for different types of bank assets and liabilities and contingent accounts as well as for separate laws and regulations that may be applicable. Documentation and accounting procedures for international operations may also differ from those used in the examination of a bank's U.S. domestic activities. The examination process may also include a review of international banking facilities (IBFs) and periodic visits to selected foreign branches and subsidiaries to determine the safety and soundness of their operations and the adequacy of reporting procedures used by the head office or parent bank to monitor the foreign office.

The global nature of economic activities has made international banking operations more important to bank customers, importers and exporters of goods and services, and a bank's domestic customers with overseas operations who require a source of international financial assistance. U.S. commercial banks provide this assistance to customers through global networks of representative offices, branches, and affiliates, as well as through correspondent relationships.

Many domestic banking activities are also conducted internationally, including providing cash and collection services, placing and taking deposits, making investments, granting loans and overdrafts, and borrowing. International examiners can reference the appropriate sections in this manual when reviewing these activities. The examination procedures for the international aspects of these and other activities are covered in the following international sections.

Certain activities that are conducted by bank on an international basis are similar to activities conducted by a bank in its domestic operations. For example, a bank may provide domestic and international customers with a letter of credit for a formal commitment to extend credit provided that certain collateral and documentary conditions exist. Foreign-exchange trading activities are similar to money-trading operations conducted at domestic funding desks. Foreign-exchange positions are similar to commodity inventories carried at book value that are exposed to fluctuating market prices. Separate international sections in this manual relate to these functions.

For other international banking activities, such as direct lease financing, installment loans, real estate loans, real estate construction loans, ownership of bank premises and equipment, and other real estate owned, examiners rely on information provided in sections entitled, "Other Assets and Other Liabilities," and "Assessment of Capital Adequacy." International examinations will also require reference to other sections of this manual. Guidelines for using these other sections in international examinations are provided below.

EXAMINATION STRATEGY

Careful planning and control are as important in international examinations as they are in domestic examinations. For more information, see this manual's section, "Examination Strategy and Risk-Focused Examinations."

When developing the scope of examination activities and identifying examiner resources, the examiner considers the bank's organization and management structure, as well as the range of international business activities and services. For example, many banks have consolidated their foreign-exchange trading and money market operations into a single division that is responsible for the bank's global money market operations. Similar situations may be encountered for other international-related functions that are combined with domestic operations.

In some examinations, examiners may encounter certain activities that are not addressed by any particular section of the international portion of this manual. In these instances, the examiner should refer to the material in other sections of this manual.

The examiner should be certain that all types of individual customer liabilities have been analyzed on a consolidated basis, regardless of the office where the bank books the activity However, since the procedures for the collection and consolidation of customer liabilities booked in overseas offices differ among banks, the examiner should determine whether the bank's accounting and financial reporting policies are adequate to provide for consolidated reporting.

INTERNAL CONTROL

Examiners should reference this manual's section entitled, "Internal Control and Audit Function, Oversight, and Outsourcing," to evaluate the objectives of and the work performed by internal and external auditors for the bank's international operations. The internal control section sets forth general criteria to be considered in evaluating the work of internal and external auditors.

EXAMINATION PLANNING

Examiners assigned to review the international activities of a bank should work closely with commercial examiners, especially in those areas in which international and domestic activities have a direct relationship. The pre-examination analysis of the bank is intended to determine high risk activities and provide for adequate staffing.

INFORMATION TECHNOLOGY

During an examination that covers information technology (IT), provided either in-house or externally, examiners should review the contents of the IT portion of the report of examination to determine which sections may be applicable to international operations. An IT examiner will generally perform the procedures in this section and should be consulted on matters applicable to international operations.

ASSET AND LIABILITY MANAGEMENT

Asset and liability management and interest-rate risk management sections of the manual are completed by domestic examiners for the entire bank, based, in part, on information prepared by examiners assigned to various international banking activities. Whether applicable segments of these sections will be completed during overseas examinations depends on the type of overseas examination conducted.

BANK-RELATED ORGANIZATIONS

Domestic examiners assigned to bank-related organizations obtain and circulate lists and information to international examiners concerning bank-related organizations involved in international activities. Besides determining the legality of the relationships, examiners should verify the accuracy and completeness of the information obtained.

REVIEW OF REGULATORY REPORTS

International examiners will prepare any necessary comments concerning regulatory reporting issues on the appropriate examination report and will discuss those comments with bank management.

LITIGATION AND OTHER LEGAL MATTERS, EXAMINATION-RELATED SUBSEQUENT EVENTS

International examiners should request from bank management a list of pending or threatened litigation and subsequent events applicable to international operations of the bank. Comments in the report of examination should be limited to events or transactions that could materially affect the soundness of the bank.

MANAGEMENT ASSESSMENT

The overall evaluation of the management of international operations should be made by the examiner assigned to review international operations who is in a position to identify the strengths and weaknesses of the bank's management team. If the scope of the examination includes the review of the operations of foreign branches and subsidiaries, examiners should assess the adequacy and effectiveness of local management of these entities.

OVERALL CONCLUSIONS REGARDING CONDITION OF THE BANK

The examiner-in-charge for the state member bank is typically responsible for overall conclusions regarding the condition of the bank. Therefore, the examiner-in-charge and those examiners assigned to review a bank's international operations should discuss and agree upon the scope of activities to be conducted on a bank's international activities. For example, certain examination procedures relating to earnings, liquidity, operational risk, management, and corporate governance and control apply to the entire bank and not to the international activities alone. Further, international examiners should assist domestic examiners in developing report comments when international activities have a significant impact on the analysis of these areas.

Acceptance. A time draft (bill of exchange or usance draft) drawn by one party and acknowledged by a second party. The drawee, known as the "acceptor," stamps or writes the word "accepted" on the face of the draft and, above his or her signature, the place and date of payment. Once the draft is accepted, it carries an unconditional obligation on the part of the acceptor to pay the drawer the amount of the draft on the date specified. A *bank acceptance* is a draft drawn on, and accepted by, a bank. A *trade acceptance* is a draft drawn by the seller of goods on the buyer and accepted by the buyer. See also *Banker's acceptance*.

Account-account dealing. Foreign-exchange dealing that involves settlement from bank-to-bank in the due from accounts. No third party (bank) is involved.

Account party. The party, usually the buyer, who instructs the bank to open a letter of credit and on whose behalf the bank agrees to make payment.

Ad valorem. A term meaning "according to value," used for assessing customs duties that are fixed as a percentage of the value stated on an invoice.

Advance. (1) A drawing or payout of funds representing the disbursement of a loan, including disbursement in stages. (2) In international banking, an extension of credit, usually recurring, in which no instrument (other than a copy of the advice of an advance) is used as evidence of a specified indebtedness, except in special cases. A signed agreement must be on file in the department and state the conditions applicable to payments made to the borrower. This loan category does not include commercial account overdrafts, but an advance may be created to finance payments effected under a commercial letter of credit, to finance payments of collections, or to refinance a maturing loan.

Advance against documents. An advance made on the security of the documents covering a shipment.

Advised letter of credit. See *Letter of credit—advised.*

Advised line. A credit authorization that will be made known to the customer. See also *Guidance line.*

Affiliate. With regard to a member bank, any company (including corporate or other forms of a business entity) of which a member bank is a subsidiary or any other subsidiary of that company.

After sight. When a draft bears this name, the time to maturity begins at its presentation or acceptance.

Agent bank. The bank that leads and documents a syndicated loan.

Aggregate limit. The total volume of unliquidated foreign-exchange contracts allowed to be outstanding at any one time.

Agreement corporation. A company chartered or incorporated under state law that, like an Edge Act corporation, is principally engaged in international banking. See also *Edge Act.*

Allocated transfer-risk reserve (ATRR). The ATRR is a special reserve established and maintained for specified international assets pursuant to the International Lending Supervision Act of 1983.[1] At least annually, the Federal Reserve and the other federal banking agencies (federal banking agencies) determine jointly—

- which international assets that are subject to transfer risk warrant establishment of an ATRR,
- the amount of the ATRR for the specified assets, and
- whether an ATRR previously established for specified assets may be reduced.

When determining whether an ATRR is required for particular international assets, the federal banking agencies consider if the quality of a banking institution's assets has been impaired by a protracted inability of public or private obligors in a foreign country to make payments on their external indebtedness, as indicated by factors as to—

- whether such obligors have failed to make full interest payments on external indebtedness, or
- whether such obligors have failed to comply with the terms of any restructured indebtedness, or
- whether a foreign country has failed to comply with any International Monetary Fund (IMF) or other suitable adjustment program, or
- whether no definite prospects exist for the orderly restoration of debt service.

1. See 12 USC 3904(a). See also the Board's January 9, 2003, approval of a revision to subpart D (on international lending supervision) of Regulation K (12 CFR 211), International Banking Operations (69 *Fed. Reg.* 1158–1161).

Also, when determining the amount of the ATRR, the federal banking agencies consider—

- the length of time the quality of the asset has been impaired,
- what recent actions have been taken to restore debt-service capability,
- the prospects for restored asset quality, and
- any other factors relevant to the quality of the asset.

The initial year's provision for the ATRR will be 10 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies. Additional provisions, if any, in subsequent years will be 15 percent of the principal amount of each specified international asset, or such greater or lesser percentage determined by the federal banking agencies.

The ATRR is established only by a charge to current income. The amounts charged cannot be included in the banking institution's capital or surplus. (For these and other requirements, as well as for certain other accounting procedures for the ATTR, the reporting and disclosure of international assets, and the accounting for fees on international loans, see sections 211.43, 211.44, and 211.45 of Regulation K.) A banking institution does not have to establish an ATRR if it writes down in the period in which the ATRR is required, or has written down in prior periods, the value of the specified international assets in the requisite amount for each such asset.

Amortizing swap. A transaction in which the notional value of the agreement declines over time.

Appreciation. A rise in the value of a currency relative to the market of another currency.

Arbitrage. Simultaneous buying and selling of foreign currencies, securities, or commodities to realize profits from discrepancies between exchange rates prevailing at the same time in different markets, between forward margins for different maturities, or between interest rates prevailing at the same time in different markets or currencies.

Asian currency unit. A foreign-exchange trading department of a bank located in Singapore that has received a license from the monetary authority in that country to deal in external currencies.

Asked price. The price sought by any prospective seller of an asset or the price at which a market maker of an asset will sell.

Assignment. The transfer in writing by one person to another of title to personal property. In banking, one bank may assign another the right to receive loan principal and interest from a borrower. The assignment of stocks or registered bonds may be effected by filling in the form printed on the reverse of the certificate.

Association of International Bond Dealers (AIBD). A private association founded in Zurich, Switzerland, in 1969 to establish uniform issuing and trading procedures in the international bond markets.

At sight. A term indicating that a negotiable instrument is payable upon presentation or demand.

At the money. A term used to refer to a call or put option whose strike price is equal (or virtually equal) to the current price of the asset on which the option is written.

Authority to pay. An advice from a buyer, sent by his or her bank to the seller's bank, authorizing the seller's bank to pay the seller's (exporter's) drafts up to a fixed amount. The seller has no protection against cancellation or modification of the instrument until the issuing bank pays the drafts drawn on it, in which case the seller is no longer liable to its bank. These instruments are usually not confirmed by the seller's American bank.

Authority to purchase. Similar to an authority to pay, except that drafts under an authority to purchase are drawn directly on the buyer. The correspondent bank purchases them with or without recourse against the drawer and, as in the case of the authority to pay, they are usually not confirmed by an American bank. This type of transaction is unique to Far Eastern trade.

Baker Plan. Proposed in 1985, this initiative encouraged banks, the IMF, and the World Bank to jointly increase lending to less developed countries (LDCs) that were having difficulty servicing their debt, provided the countries undertook prudent measures to increase productive growth.

Balance of payments. A term indicating a nation's external cash flow (to other countries, whether positive or negative) for a given period of time, including trade, current financial, and capital inflows and outflows.

Balance of trade. The difference between a country's total imports and total exports for a given period of time. A "favorable" balance of trade exists when exports exceed imports.

Band. The maximum range that a currency may fluctuate from its parity with another currency or group of currencies by official agreement.

Bank for International Settlements (BIS). Established in 1930 in Basel, Switzerland, the BIS is the oldest functioning international financial organization. It provides a forum for frequent consultation among central bankers on a wide range of issues.

Banker's acceptance. A time draft that has been drawn on and accepted by a bank. The bank accepting the time bill becomes primarily liable for payment. See also *Acceptance*.

Banker's acceptance liability. The moment the draft is accepted by the bank, a direct liability is recorded in its "Acceptances Executed" account. The contra account on the asset side of the balance sheet is "Customer's Liability on Acceptances." On the date of maturity of the banker's acceptance, the bank charges the customer's account and retires the acceptance by paying the beneficiary or drawee of the draft. The bank's liability records at this point are liquidated, and the transaction is completed.

Barter. The exchange of commodities using merchandise as consideration instead of money. This scheme has been employed in recent years by countries that have blocked currencies.

Base rate. A rate used as the basis or foundation for determining the current interest rate to be charged to a borrower, such as the prime rate or London Interbank Offered Rate (LIBOR).

Basel Capital Accord. An agreement among the central banks of leading industrialized countries, including those of Western Europe, Canada, the United States, and Japan, to impose common capital requirements on their internationally active banks to take into account bank risk exposure.

Basis. The cash or spot price minus the futures price.

Basis risk. The risk associated with nonparallel movement of interest rates. Banks face exposure in two situations. The first occurs when an operator uses, for example, a Treasury bill to hedge an interest-rate risk in Eurodollars. The interest rates for T-bills and Eurodollars do not always move exactly parallel to each other. The risk of this lack of parallel movement is basis risk. The second occurs when the period of time for which a financial risk exists is not identical with the period of time for which the hedge is arranged, for example, when a three-month interest risk in a revolving Eurodollar loan is hedged with a six-month futures contract in Eurodollars. A change in the shape of the yield curve can bring about nonparallel movements in interest rates for the two different maturities.

Basis swap. A transaction in which one participant pays a floating rate of interest based on one index, and the other party pays a floating rate of interest based on another interest-rate index.

Beneficiary. The person or company in whose favor a letter of credit is opened or a draft is drawn.

Bid-asked spread. The difference between a bid and the asked price, for example, the difference between 0.4210 and 0.4215 would be a spread of 0.0005 or 5 points.

Bid rate. The price at which the quoting party is prepared to purchase a currency or accept a deposit. If the bid rate is accepted by the party to whom it was quoted, then that party will sell currency or place or lend money at that price. The opposite transaction takes place at the offer rate.

Bilateral trade. Commerce between two countries, usually in accordance with specific agreements on amounts of commodities to be traded during a specific period of time. Balances due are remitted directly between the two nations.

Bill of exchange. An instrument by which the drawer orders another party (the drawee) to pay a certain sum to a third party (the payee) at a definite future time. The terms "bill of exchange" and "draft" are generally interchangeable.

Bill of lading. A receipt issued by a carrier to a shipper for merchandise delivered to the carrier for transportation from one point to another. A bill of lading serves as a receipt for the goods, document of title, and contract between the carrier and the shipper covering the delivery of the merchandise to a certain point or designated person. It is issued in two primary forms: an "order bill of lading," which provides for the delivery of goods to a named person or to his or her order (designee), but only on proper endorsement and surrender of the bill of lading to the carrier or its agents, and a "straight bill of lading," which provides for delivery of the goods only to the person designated by the bill of lading.

- *Clean bill of lading*. A bill of lading in which the described merchandise has been received

in "apparent good order and condition" and without qualification.
- *Ocean bill of lading*. A document signed by the captain, agents, or owners of a vessel furnishing written evidence for the conveyance and delivery of merchandise sent by sea. It is both a receipt for merchandise and a contract to deliver it as freight.
- *Order bill of lading*. A bill of lading, usually drawn to the order of the shipper, that can be negotiated like any other negotiable instrument.
- *Order "notify" bill of lading*. A bill of lading usually drawn to the order of the shipper or a bank with the additional clause that the consignee is to be notified upon arrival of the merchandise. However, the mention of the consignee's name does not confer title to the merchandise.
- *Stale bill of lading*. A bill of lading that has not been presented under a letter of credit to the issuing bank within a reasonable time after its date, thus precluding its arrival at the port of discharge by the time the ship carrying the related shipment has arrived.
- *Straight bill of lading*. A bill of lading drawn directly to the consignee and therefore not negotiable.
- *Through bill of lading*. A bill of lading used when several carriers are used to transport merchandise, for example, from a train to a vessel or vice versa.
- *Unclean bill of lading*. A bill of lading across the face of which exceptions to the receipt of goods "in apparent good order" are noted. Examples of exceptions include burst bales, rusted goods, and smashed cases.

Black market. A private market that operates in contravention of government restrictions.

Blocked account. An account from which payments, transfers, withdrawals, or other dealings may not be made without Office of Foreign Asset Control (OFAC) or U.S. Treasury Department approval. Although the bank is prohibited from releasing funds from these accounts, deposits may be accepted. Banks are subject to significant fines for releasing funds from blocked accounts. See also *Office of Foreign Asset Control, Specially designated nationals*.

Blocked currency. A currency that is prohibited by law from being converted into another foreign currency.

Book-entry form. The method by which marketable securities are issued with the buyer receiving only a receipt rather than an engraved certificate, which indicates that the purchase is recorded on the issuer's books or recorded in another approved location.

Brady Plan. Proposed in 1989 and named after then U.S. Treasury Secretary Nicholas Brady, the Brady Plan sought to reduce the debt-service requirements of various developing countries and to provide new loans (Brady bonds) to service existing obligations.

Break-even exchange rate. The particular spot exchange rate that must prevail at the maturity of a deposit or debt in a foreign currency (which has not been covered in the forward market) so that there will be no advantage to any party from interest-rate differentials.

Bulldog bonds. British pound sterling–denominated foreign bonds issued in London.

Bullion. Unminted precious metals (gold, silver) of standard or stipulated fineness in the form of bars, ingots, or nuggets. The value of gold bullion, usually in bars, used in the settlement of international balances is determined by weight and degree of fineness.

Buyer's option contract. A contract in which the buyer has the right to settle a forward contract at any time within a specified period. See also *Option contracts*.

Buying rates. Rates at which foreign-exchange dealers will buy a foreign currency from other dealers in the market and at which potential sellers are able to sell foreign exchange to those dealers.

C & I loans. Commercial and industrial loans.

Cable. A message sent and delivered by an international record carrier via satellite or cable connections to a foreign country. "Cable" as used in the international sections also includes messages transmitted by bank telex. The terms "cable" and "telex" are generally used interchangeably.

Call money. Funds placed with a financial institution without a fixed maturity date. The money can be "called" (withdrawn) at any time by telephone. "Same day" call money means the call must (usually) be made before 10:00 a.m. In addition, "24-hour," "48-hour," and "7-day" call money means the money must be called one, two, or seven calendar days before the actual payment date. Although these are the most common varieties of call money, two parties can agree on different dates.

Call option. A contract giving the purchaser the right, but not the obligation, to buy an asset at a stated price on or before a stated date.

Capital controls. Governmental restrictions on the acquisition of foreign assets or foreign liabilities by domestic citizens or restrictions on the acquisition of domestic assets or domestic liabilities by foreign citizens.

Cedel. Formerly one of the two main clearing systems in the Eurobond market, Cedel, based in Luxembourg, began operations in 1971. Cedel ceased to exist as an independent entity as part of a merger with Clearstream International clearinghouse in 2000. The merger was completed in 2002.

Central bank intervention. Direct action by a central bank to increase or decrease the supply of currency to stabilize prices in the spot or forward market or to move them in a desired direction. On occasion, the announcement of an intention to intervene might achieve the desired results.

Certificate of inspection. A document often required for shipment of perishable goods in which certification is made as to the good condition of the merchandise immediately before shipment.

Certificate of manufacture. A statement, sometimes notarized, by a producer who is usually also the seller of merchandise that manufacture has been completed and that goods are at the disposal of the buyer.

Certificate of origin. A document issued by the exporter certifying the place of origin of the merchandise to be exported. The information contained in this document is needed primarily to comply with tariff laws that may extend more favorable treatment to products of certain countries.

Chain. A method of calculating cross rates. For example, if a foreign-exchange trader knows the exchange rate for Japanese yen against U.S. dollars and for Swiss francs against U.S. dollars, the "chain" makes possible a calculation of the cross rates for Japanese yen against Swiss francs.

Charges forward. A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawee.

Charges here. A banking term used when foreign and domestic bank commission charges, interest (if any), and government taxes in connection with the collection of a draft are for account of the drawer.

Charter party. A contract, expressed in writing on a special form, between the owner of a vessel and the one (the charterer) desiring to employ the vessel, setting forth the terms of the arrangement, such as freight rate and ports involved in the trip contemplated.

Chicago Board of Trade (CBT). A futures exchange that merged with the Chicago Mercantile Exchange in 2007 and ceased to exist as an independent entity.

Chicago Board Options Exchange (CBOE). An options exchange in which European foreign-currency options on spot exchange are traded.

Chicago Mercantile Exchange (CME). A futures exchange.

Clean collection. A collection in which a draft or other demand for payment is presented without additional attached documentation.

Clean draft. A sight or time draft to which no other documents, such as shipping documents, bills of lading, or insurance certificates, are attached. This is to be distinguished from a documentary draft. See also *Documentary draft*.

Clean risk at liquidation. A type of credit risk that occurs when exchange contracts mature. There may be a brief interval (usually no more than a few hours) during which one of the parties to the contract has fulfilled its obligations, but the other party has not. During this period, the first party is subject to a 100 percent credit risk, on the chance that, in the interval, an event may prevent the second party from fulfilling its obligations under the contract.

Clearing corporation. A clearinghouse that exists as an independent corporation rather than as a subdivision of an exchange.

Clearinghouse. A subdivision of an exchange or an independent corporation through which all trades must be confirmed, matched, and settled daily until offset.

Clearinghouse funds. Funds used in settlement of a transaction that are available for use or that become good funds after one business day.

Clearing House Interbank Payments System (CHIPS). A computerized telecommunications network provided by the New York Clearing House Association (NYCHA), which serves as an automated clearinghouse for interbank funds transfers.

Closing a commitment. Allowing a covered foreign-exchange position to expire on maturity or reversing it before maturity by a swap operation.

Closing a position. Covering open long or short positions by means of a spot operation and/or outright forward operation.

Comanager. A bank ranking just below that of lead manager in a syndicated Eurocredit or an international bond issue. The status of comanager usually indicates a larger share in the loan or a larger bond allotment, and a larger share in the fees, than banks of lower rank. Comanagers may also assist the lead managers in assessing the market or determining terms of the loan.

Combined transport document. A through bill of lading that applies to more than one mode of transport.

Commercial paper. A short-term, unsecured debt instrument issued by a corporation and sold at a discount from its maturity value.

Commercial transaction. A transaction between a dealing bank and a nonbanking (commercial) party.

Commodities Futures Trading Commission (CFTC). A U.S. regulatory body that regulates exchange-based futures trading in the United States.

Commodity Credit Corporation (CCC). An instrument of the federal government whose principal purpose is to provide the necessary financial services to carry forward the public price-support activities, including government lending, purchasing, selling, storing, transporting, and subsidizing certain agricultural commodities.

Common carrier. An individual, partnership, or corporation, such as a shipping line, railroad, or airline, that undertakes for hire to transport persons or commodities from place to place. Governed by special laws, common carriers must accept all business offered them under their regulations.

Compromises. Occasions when both parties agree to alter the terms of an existing foreign-exchange contract. These alterations should be approved by an impartial bank officer and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original terms.

Confirmation. The written communication to the counterparty in a foreign exchange, interbank deposit, or other money market transaction that recites all the relevant details agreed upon by phone or telex.

Confirmed letter of credit. See *Letter of credit*.

Consignment. The physical transfer of goods from a seller (consignor), with whom the title remains, to another legal entity (consignee), who acts as a selling agent, selling the goods and remitting the net proceeds to the consignor.

Consular documents. Bills of lading, certificates of origin, or special forms of invoice that carry the official signature of the consul of the country of destination.

Consular invoice. A detailed statement on the character of goods shipped, which is duly certified by the consul at the port of shipment. Required by certain countries, including the United States, its principal function is to accurately record the types of goods and their quantity, grade, and value for import duty and general statistical purposes.

Contract limit. A maximum limit on the total gross notional principal amount of outstanding contracts booked with one customer.

Contract risk (counterparty risk). Risk that the counterparty will default before settlement.

Convertibility. Freedom to exchange a currency, under certain circumstances, without government restrictions or controls.

Correspondent bank. A bank located in one geographic area that accepts deposits from a bank in another region and provides services on behalf of this other bank. Internationally, many banks maintain one account with a correspondent bank in each major country to be able to make payments in all major currencies. Correspondent banks are usually established on a reciprocal basis.

Cost, insurance, and freight (C.I.F.). A price quotation under which the seller defrays all expenses involved in the delivery of goods.

Counterpart funds. Local currencies deposited in a special account by recipient governments that represent grant aid extended by another government. Those funds, while remaining the property of the recipient government, can generally be used only by agreement of the donor government.

Country exposure. A measurement of the volume of assets and off-balance-sheet items considered to be subject to the risk of a given country. This measurement is based, in part, on identifying the country of domicile of the entity ultimately responsible for the credit risk of a particular transaction.

Country limit. The amount of money that a bank has established as the maximum it is willing to lend borrowers in a given country regardless of the type of borrower or the currencies involved.

Country risk. Refers to the spectrum of risks arising from the economic, social, and political environment of a given foreign country, which could have favorable or adverse consequences for foreigners' debt and/or equity investments in that country.

Cover. The execution of an offsetting foreign-exchange trade to close or eliminate an open exposure.

Covered interest arbitrage. The process of taking advantage of a disparity between the net accessible interest differential between two currencies and the forward exchange premium or discount on the two currencies against each other.

Crawling peg system. An exchange-rate system in which the exchange rate is adjusted every few weeks, usually to reflect prevailing inflation rates.

Credit risk. The possibility that the buyer or seller of foreign exchange or some other traded instrument may be unable to meet his or her obligation on maturity.

Credit swap. A link transaction wherein one party places a deposit in one currency (probably dollars) with a foreign bank during the period that the foreign bank lends another currency to a third party. The deposit serves as an inducement for the transaction, and its value is considered in pricing the loan.

Cross-border exposure. The risk that arises when an office of a bank, regardless of its location or currency, extends credit to a borrower that is located outside the booking unit's national border.

Cross-currency risk. The risk associated with maintaining exchange positions in two foreign currencies as the result of one transaction. For example, if a U.S. operator borrows Swiss francs at 5 percent and invests the proceeds in British pounds at 12 percent, the cross-currency risk is the chance that the pounds will depreciate in value against the Swiss francs to such an extent that there will be a loss on the transaction in spite of the favorable interest-rate differential.

Cross-default. A term used to describe a clause in a syndicated loan or bond contract that gives the lender the right to accelerate repayment of the loan if the borrower defaults on another loan.

Cross-hedging. The hedging of an asset with a futures contract of a different asset.

Cross rate. The ratio between the exchange rates of two foreign currencies in terms of a third currency.

Currency futures and options contracts. An agreement that allows businesses or individuals acquiring or selling foreign currencies to protect themselves against future fluctuations in currency prices by shifting currency risk to someone willing to bear that risk.

Currency liquidity. In a multicurrency investment portfolio, the liquidity of a given foreign currency has to be viewed in terms of exchange liquidity and instrument liquidity. Exchange liquidity depends on the ease with which a currency can be converted into and out of another major currency. Instrument liquidity depends on the ease with which a negotiable instrument denominated in that currency can be purchased and sold without noticeably affecting the market rate for that instrument.

Currency swap. A contractual obligation entered into by two parties to deliver a sum of money in one currency against a sum of money in another currency at stated intervals (or a stated interval) or according to negotiated terms. See *Swap*.

Current account. Those items in the balance of payments involving imports and exports of goods and services as well as unilateral transfers.

Customs union. An agreement between two or more countries in which they arrange to abolish tariffs and other import restrictions on each other's goods and to establish a common tariff for the imports of all other countries.

Date draft. A draft drawn to mature on a fixed date, regardless of its acceptance.

Daylight limit. The maximum net foreign-exchange position that a bank will allow during business hours.

Dealer (or trader). A person who executes foreign-exchange, interbank deposit, or other money market trades for a dealing bank.

Debt for equity swaps. Debt (usually LDC government debt) that is discounted and exchanged for equity in local businesses (often newly privatized).

Debt swaps. The exchange of LDC loans based on the prices quoted in the secondary market. Swaps are often used to decrease exposure to certain countries.

Default risk. The risk to the holder of debt securities that a borrower will not meet all promised payments at the times agreed upon.

Del credere agent. A sales agent who, for a certain percentage above his or her sales commission, guarantees payment to the person for whom he or she is selling on shipments made to the seller's customers.

Delivery. The offset of an obligation to buy or sell an asset by an actual transfer of title to the asset at a prearranged price. In the futures market, the transfer or receipt of a cash instrument against a short or long futures contract.

Delivery order. An order addressed to the holder of goods and issued by anyone who has authority to do so, that is, by one who has the legal right to order delivery of merchandise. A delivery order is not considered a good titled document.

Delivery risk. The possibility that a seller of foreign exchange, having collected the payment in local currency, may fail to deliver the exchange in the foreign center where it was sold. Also called settlement risk.

Delta of an option. The rate of change of the value of an option with respect to the price of the underlying asset, reference rate, or index evaluated at the current market price of that underlier.

Demand draft. A draft that is payable immediately upon presentation to the drawee. This type of draft is also termed a ‘‘sight’’ or ‘‘presentation’’ draft.

Deposit dealer. A term used in the United States for bank personnel responsible for lending and borrowing funds in the interbank market.

Deposit trader. A term used in Europe for bank personnel responsible for lending and borrowing funds in the interbank market.

Depreciation. A drop in the value of a currency relative to the value of another currency.

Depth of the market. The amount of currency that can be traded in the market at a given time without causing a price fluctuation. Thin markets are usually characterized by wide spreads and substantial price fluctuations during a short period of time. Strong markets tend to be characterized by relatively narrow spreads of stable prices.

Derivative instrument. An instrument that is based on or derived from the value of an underlying asset, reference rate, or index. For example, interest-rate futures are based on various types of securities trading in the cash market. Some interest-rate options are derived from interest-rate futures.

Devaluation. An official act wherein the official parity of a country’s currency is adjusted downward to the dollar, gold, Special Drawing Rights (SDRs), or another currency. After a devaluation, there are more devalued currency units relative to the dollar, gold, SDRs, or other currency. See also *Revaluation*.

Development bank. A lending agency that provides assistance to encourage economic development.

Direct quote. The method of quoting fixed units of foreign exchange in variable numbers of the local currency unit. Also called a ‘‘fixed’’ or ‘‘certain’’ quotation.

Dirty float (or Managed float). A floating exchange-rate system in which some government intervention still takes place. A government may announce that it will let its currency float, that is, it will let the currency’s value be determined by the forces of supply and demand in the market. The government, however, may secretly allow its central bank to intervene in the exchange market to avoid too much appreciation or depreciation of the currency.

Discount.

- *Lending*—To subtract from a loan, when it is first made, the amount of interest that will be due when it is repaid.
- *Foreign exchange*—The amount by which the forward exchange rate of one currency against another currency is less than the spot exchange rate between the two currencies.
- *Financial*—A deduction from the face value of commercial paper, such as bills of exchange and acceptances, in consideration of cash the seller has received before the maturity date. The rates of discount vary according to the state of the given money market, the financial standing of the persons involved, and other circumstances surrounding the transaction.
- *Commercial*—An allowance from the quoted price of goods, usually made by the deduction of a certain percentage from the invoice price.

Discount rate. Most commonly the rate at which a Federal Reserve Bank (or, in many instances, foreign central banks) is prepared to lend to financial institutions against eligible collateral.

Dishonor. Refusal on the part of the drawee to accept a draft or to pay it when due.

Divergence indicator system. One aspect of the European Monetary System that measures the departure of a country’s economic policies from the European Union’s ‘‘average.’’ The measure of divergence is based exclusively on the movement of a country’s exchange rate with respect to the euro.

Dock receipt. A receipt issued by an ocean carrier or its agent for merchandise delivered at its dock or warehouse that is awaiting shipment.

Documentary collection. A collection in which a draft is accompanied by shipping or other documents.

Documentary credit. A commercial letter of credit providing for payment by a bank to the named beneficiary, who is usually the seller of merchandise, against delivery of documents specified in the credit.

Documentary draft. A draft to which documents are attached, that is delivered to the drawee upon acceptance or payment of the draft and that ordinarily controls title to the merchandise.

Documents. The shipping and other papers customarily attached to foreign drafts, consisting of ocean bills of lading, marine insurance certificates, and commercial invoices. Certificates of origin and consular invoices may also be required.

Documents against acceptance (D/A). Instructions given by an exporter to a bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her acceptance of the draft.

Documents against payment (D/P). Instructions given by an exporter to his or her bank that the documents attached to a draft for collection are deliverable to the drawee only against his or her payment of the draft.

Domestic bond. A domestic debt security sold by an issuer in its own country and denominated in that country's currency.

Domicile. The place where a draft or acceptance is made payable.

Draft. An order in writing signed by one party (the drawer) requesting a second party (the drawee) to make payment at a determinable future time to a third party (the payee). It may be accompanied by a bill of lading, which the bank will surrender to the buyer upon payment of the draft. The buyer may then claim the goods at the office of the carrier who transported them to the buyer's place of business. See also *Sight draft* or *Time draft*.

Dragon bond. A bond issued by a foreign borrower in an Asian or Pacific country (excluding Japan—see *Samurai bond)*.

Drawee. The addressee of a draft, that is, the person on whom the draft is drawn.

Drawer. The issuer or signer of a draft.

Duration. A time-weighted present-value measure of the cash flow of a loan or security that takes into account the amount and timing of all promised interest and principal payments associated with that loan or security.

Duty. (1) Ad valorem duty (according to the value) is an assessment at a certain percentage rate on the actual value of an article. (2) Specific duty is an assessment on the weight or quantity of an article without reference to its monetary value or market price. (3) Drawback is a recovery in whole or in part of duty paid on imported merchandise at the time of reexportation, whether in the same or different form.

Edge Act. Incorporated as section 25A of the Federal Reserve Act, this act authorizes the Board of Governors to charter corporations (Edge corporations) for the purpose of engaging in international or foreign banking or in other international operations.

Eligible acceptance. A banker's acceptance that meets Federal Reserve requirements related to its financing purpose and term.

Eligible value date. A normal business day on which a payment to settle a money market transaction can be made. An eligible value date for a foreign-exchange transaction must be a business day in the home countries of both of the currencies involved.

Engineered swap transaction. A spot transaction and an offsetting forward transaction in which each of the two transactions is carried out with a different party.

Eurobank. A bank that regularly accepts foreign currency-denominated deposits and makes foreign-currency loans.

Eurobonds. Long-term debt securities denominated in a currency other than that of the country or countries where most or all of the security is sold.

Euroclear. Euroclear Clearance System Limited is one of two main clearing systems in the Eurobond market. Euroclear, which began operations in December 1968, is located in Brussels and managed by Euroclear Bank SA. See also *Cedel*.

Eurocurrency. The nonresident ownership of one of the major western European currencies. Eurocurrencies, similar to Eurodollars, are frequently available for borrowing in the London Interbank Market.

Eurocurrency market. The money market for borrowing-and-lending currencies that are held in the form of deposits in banks located outside the countries in which those currencies are issued as legal tender.

Eurodollars. Dollar deposit claims on U.S. banks that are deposited in banks located outside the United States, including foreign branches of U.S. banks. These claims, in turn, may be redeposited with banks or lent to companies, individuals, or governments outside the United States.

Eurodollar deposit rate. The interest rate at which a quoting bank is willing to take wholesale Eurodollar funds with a particular maturity from other than an interbank participant. The rate is usually one-eighth to one-sixteenth of one percent lower than LIBOR.

European Currency Unit (ECU). A portfolio currency used in the European Monetary System as a community "average" exchange rate. It was also used in the private market as a means of payment and as a currency of denomination for lending, borrowing, and trade. On January 1, 1999, the euro replaced the ECU.

European Monetary System (EMS). An arrangement introduced in March 1979 for economic and monetary cooperation among the members of the European Union. The ultimate aim of the EMS is a single European currency and the establishment of a European central bank.

European Union (EU). Formerly the European Community, an economic association of European countries founded by the Treaty of Rome in 1957. The goals of the EU are the removal of trade barriers among countries, the formation of a common commercial policy toward non-EU countries, and the removal of barriers restricting competition and the free mobility of factors of production. Members include Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom.

Exchange contracts. Documents issued by foreign-exchange dealers, banks dealing in foreign exchange, and foreign-exchange brokers confirming foreign-exchange transactions.

Exchange control or restrictions. Limits on free dealings in foreign exchange or of free transfers of funds into other currencies and other countries.

Exchange control risk. The possibility of defaults on obligations by imposing or reinforcing exchange control.

Exchange-rate differential. The difference between two exchange rates in a swap transaction.

Exchange rates. The price of one currency in terms of another. See also *Spot exchange, Buying rates, Fixed rate of exchange, Floating rate,* and *Interbank rate of exchange.*

Exchange reserves. The total amount of freely convertible foreign currencies held by a country's central bank.

Exchange risk. The possibility of a loss on an open position as a result of an appreciation or depreciation of the exchange.

Exercise. The use of the right given by an option: purchase (if a call) or sale (if a put) of an asset at the strike price stated in the option contract.

Exit bonds. Low-interest government bonds issued in LDCs that are equivalent to a portion of the country's existing bank debt. Designed to facilitate debt management.

Expiration date. The last day on which an option may be exercised.

Export credit insurance. A system to insure the collection of credits extended by exporters against various contingencies. In some countries, only noncommercial risks can be insured.

Export declaration. A document required by the U.S. government for shipments abroad and used to maintain statistics on our exports.

Export-Import Bank of the United States (Eximbank). An institution that provides intermediate and long-term nonrecourse financing for U.S. exports when these facilities are not available from commercial banks. All of the Eximbank's shares are held by the U.S. Treasury.

Export trading company (ETC). A company designed to facilitate U.S. exports. An ETC may be an affiliate of a bank holding company.

Fail. Nonperformance of an obligation on the specified day, for example, failure to make prompt settlement for either side of a foreign-exchange contract, usually due to a clerical or trader error. A fail usually leads to an interest adjustment for an overdraft in the paying or receiving bank.

F.A.S. See *Free alongside ship.*

Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). This act had various aims, including the least-cost resolution of troubled insured depository institutions, improvement of bank supervision and examinations, and provision of additional resources to the Bank Insurance Fund.

Federal funds. Deposits held by commercial banks at a Federal Reserve Bank. Since reserve requirements of commercial banks are satisfied by federal funds, banks with deposits in excess of required reserves will lend the excess deposits to banks with a reserve shortage at a market-determined interest rate, called the federal funds rate.

Federal Reserve System. The central bank of the United States, created by the Federal Reserve Act of 1913, consisting of the Board of Governors in Washington, D.C., and 12 regional Federal Reserve Banks. The Federal Reserve controls the country's monetary base and has the power to set reserve requirements, conduct open-market operations, and lend directly to banks.

Fedwire. The large-value payment mechanism owned and operated by the Federal Reserve System. Fedwire provides depository institutions with real-time settlement in the central bank of funds transfers and book-entry securities transfers made for their own account or on behalf of their customers.

Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The purpose of this act was to reform, recapitalize, and consolidate the federal deposit insurance system and to enhance the regulatory and enforcement powers of federal financial institutions' regulatory agencies.

Fixed exchange-rate system. A system in which the exchange rate of a country's currency is tied to one major currency, such as the U.S. dollar.

Fixed rate of exchange. A rate of exchange set by a foreign government relative to the dollar, gold, another currency, or perhaps Special Drawing Rights. It remains in effect as long as that government is willing or able to buy and sell at the set rates.

Fixed-rate payer. A position applicable to a rate swap, in which the fixed payer pays the fixed rate and receives the floating rate.

Flexible rate of exchange. A rate of exchange subject to relatively frequent changes. It is determined by market forces but subject to various floors or ceilings relative to the dollar, gold, Special Drawing Rights, or another currency when the rate fluctuates beyond certain parameters.

Floating exchange-rate system. A system in which the values of the currencies of various countries relative to each other are established by supply and demand forces in the market without government intervention.

Floating rate. A rate of exchange that is determined completely by market forces, with no floor or ceiling vis-a-vis the dollar, gold, Special Drawing Rights, or another currency.

Floating-rate notes. Bonds that pay interest at an agreed margin above a market reference rate. The interest rate varies according to variations in the market reference rate.

Floating-rate payer. A position applicable to a rate swap, in which the floating payer pays the floating rate and receives the fixed rate.

F.O.B. See *Free on board (destination* or *vessel)*.

Foreign Bank Supervision Enhancement Act (FBSEA). Part of the FDIC Improvement Act of 1991, FBSEA expanded the supervisory authority of the Federal Reserve over the U.S. operations of foreign banks.

Foreign bonds. Bonds issued by nonresidents but underwritten primarily by banks registered in the country where the issue is made.

Foreign Credit Insurance Association (FCIA). An insurance company established under the auspices of Eximbank. Insurers trade credits granted by U.S. suppliers of products to purchasers abroad who qualify as normal risks. The insurance protects the exporter, up to an agreed percentage, against any nonpayment resulting from commercial or political risks, or both. Eximbank provides reinsurance for the entire portion of the commercial credit risk and is the sole insurer of the political risk.

Foreign currency. The currency of any foreign country that is the authorized medium of circulation and the basis for recordkeeping in that country. Foreign currency is traded by banks either by the actual handling of currency and checks or by the establishment of balances in foreign currencies with banks in those countries.

Foreign deposits. Those deposits that are payable at a financial institution outside the jurisdiction of the U.S. government and in the currency of the country in which the depository is located. See also *Nostro account*.

Foreign draft. An official bank order drawn on a foreign correspondent bank to pay on demand to a designated payee a specific sum of foreign money or U.S. dollars at the drawee's buying rate.

Foreign exchange. The trading or exchange of a foreign currency in relation to another currency.

Foreign-exchange futures contracts. Standardized contracts traded on an organized futures exchange and settled through the clearinghouse of the exchange. Each contract defines the currencies, contract amounts, and delivery dates for its own contracts.

Foreign-exchange market. Communications between dealers and brokers to transact wholesale business in foreign exchange and Eurocurrencies.

Foreign-exchange rationing. A government requirement that all holders of bills of exchange relinquish them at a stipulated rate.

Foreign-exchange reserves (official). The reserves maintained by a central bank, which usually include gold and easily traded currencies of major industrial nations.

Foreign-exchange risk. The risk associated with exposure to fluctuation in spot exchange rates.

Foreign Investment Advisory Service (FIAS). Established in 1986, FIAS counsels developing countries on attracting foreign capital. FIAS operates under the aegis of the World Bank and its affiliates, the International Finance Corporation and the Multilateral Investment Guarantee Agency.

Foreign trade zone. An area where goods may be received and stored without entering a country's customs jurisdiction and without paying duty. Sometimes called a "free trade zone."

Forward book. The aggregate of all forward contracts for a given currency or all currencies.

Forward contract. A contract that obligates one party to sell and another to buy a specific asset for a specified price at a designated time.

Forward discount ("at a forward discount"). A phrase used to describe a currency whose forward price is cheaper than its spot price.

Forward exchange. Foreign currency traded for settlement beyond two working or business days from today.

Forward exchange position. The long or short position that a dealer may have in the forward market, as compared to spot dealing.

Forward exchange risk. The possibility of a loss on a covered position as a result of a change in the swap margin.

Forward-forward dealing. The simultaneous purchase and sale of a currency for different forward dates.

Forward premium ("at a forward premium"). A phrase used to describe a currency whose forward price is more expensive than its spot price.

Forward purchase. An outright purchase of a forward contract.

Forward rates. The actual rates at which foreign exchange for future delivery are quoted, bought, and sold.

Forward swap. A transaction in which the initial fixed- and floating-rate payments are deferred until a future period of time.

Forward transaction date. Value dates that are more than two business days following the trade date. Regular forward dates are 30, 60, and 90 days from the trade date.

Free alongside ship (F.A.S.). A term for a price quotation under which the seller delivers merchandise free of charge to the steamer's side and pays lighterage expenses up to that destination, if necessary.

Free on board (F.O.B.) (destination). A term for a price quotation under which the seller undertakes at his or her risk and expense to load the goods on a carrier at a specified location. Expenses subsequent thereto are for account of the buyer.

Free on board (F.O.B.) (vessel). A term for a price quotation under which the seller delivers the goods at his or her expense on board the steamer at the location named. Subsequent risks and expenses are for account of the buyer.

Free port. A foreign trade zone, open to all traders on equal terms, where merchandise may be stored duty-free pending its reexport or sale within that country.

Free trade area. An arrangement between two or more countries for free trade among themselves, although each nation maintains its own independent tariffs toward nonmember nations. It should not be confused with "free trade zone," which is synonymous with "foreign trade zone."

Fungible securities. Securities that are not individually designated by serial number as belonging to a particular owner. Instead, a clearing system or depository institution credits owners with a given number of a particular bond issue (or other security issue). The owner may have title to 50 bonds, but not to 50 specific bonds with designated serial numbers.

Futures commission merchant (FCM). A firm that is registered with the CFTC and legally authorized to solicit or accept orders from the public for the purchase or sale of futures contracts. Acts as an intermediary between a public customer and a floor broker.

Futures contract. An exchange-traded contract in which one party agrees to buy a security and another agrees to sell a security in the future. If held until maturity, the futures contract may involve accepting (if long) or delivering (if short) the asset on which the futures price is based.

Futures market. A market in which contracts are traded for future delivery of commodities, currencies, and financial instruments. The purchase or sale of a futures contract requires that a deposit, called margin, be maintained with a broker. The market is designed in such a way that it is easy to get out of a contract or cancel. The vast majority of participants, the buyers and sellers of futures contracts, do not intend to take delivery or deliver what they bought or sold. Futures contracts are used as an investment vehicle and as a vehicle for hedging positions.

G-10 countries. The informal term for the

Group of 10 countries, which consists of Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, the United Kingdom, and the United States. Switzerland joined in 1984, but the name remains as is.

Gap. The period, in foreign-exchange transactions, between the maturities for purchases and those for sales of each foreign currency (exchange gap). In money market transactions, the period between the maturities of placements (loans) and the maturities of borrowing (deposits) of each currency (money market gap). The former occurs when a currency is purchased against one currency and sold against another, each time for different maturities. The money market gap is created by lending an amount of a certain currency for a longer or shorter period than that for which the same currency is borrowed.

Global bond. A temporary debt certificate issued by a Eurobond borrower, representing the borrower's total indebtedness. The global bond will subsequently be replaced by individual bearer bonds.

Global line. A bank-established aggregate limit that sets the maximum exposure the bank is willing to have to any one customer on a worldwide basis. See also *Multicurrency line*.

Gray market. A forward market for newly issued bonds that takes the form of forward contracting between market participants during the period between the announcement day of a new issue and the day final terms of the bond issue are signed. Bonds are traded at prices stated at a discount of premium to the issue price.

Group of Eight (G-8). A group of industrialized countries comprising Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States.

Guidance line. An authorization, unknown to the customer, for a line of credit. If communicated to the customer, the guidance line becomes an advised line of credit commitment.

Hard currency. The term ''hard currency'' is a carryover from the days when sound currency was freely convertible into ''hard'' metal, that is, gold. It is used today to describe a currency that is sufficiently sound so that it is generally accepted internationally at face value.

Hedging. A transaction used by dealers in foreign exchange, commodities, or securities, as well as manufacturers and other producers, to protect against severe fluctuations in exchange rates and prices. A current sale or purchase is offset by contracting to purchase or sell at a specified future date. The object is to defer a profit or loss on the current purchase or sale by realizing a profit or loss on a future purchase or sale. The hedge contract may run for a period that coincides with the expected liquidation of the asset or it may merely last for one, three, six, or twelve months to offset the exchange risk for an asset that is expected to be held for a long term, in which case the choice of the term of the hedge is a matter of relative cost and judgment. Also referred to as ''covering.''

Host currency. See *Local currency*.

Hot money. Funds temporarily transferred to a financial center and subject to withdrawal at any moment.

ICERC. See *Interagency Country Exposure Review Committee*.

Impact loan. A loan specifically designated by a government as important for the development of the country. It usually involves production for export. The term is most often used in regard to Japanese loans.

Implied forward rate. The rate of interest at which a borrowing or a lending transaction of a shorter maturity may be rolled over to yield an equivalent interest rate with a borrowing or a lending transaction of longer maturity.

Indirect quote. Quotation of a fixed unit of the local currency in variable units of foreign currencies.

Ineligible acceptance. An acceptance that does not meet the Federal Reserve eligibility requirements for use at the discount window.

In the money. A term used to refer to a call option whose strike price is below or a put option whose strike price is above the current price of the asset on which the option is written.

Initial margin. The minimum deposit a futures exchange requires from customers for any futures contract in which a customer has a net long or short position.

Interagency Country Exposure Review Committee (ICERC). A nine-member joint committee of three federal regulatory agencies established to administer the country risk supervision program. ICERC centralizes decision making for determinations about the creditworthiness of individual countries.

Interbank offered rate (IBOR). The rate at which banks will lend to other banks for a particular currency at a particular location.

Interest arbitrage. Involves the movement of short-term funds from one currency to another for the purpose of investing idle funds at a higher yield. However, the real yield advantage in this situation is not merely the difference in interest rates between the two investment choices, but rather the difference in subtracting the cost of transferring funds into the desired currency and back again from the interest differential. There are four types of interest arbitrage: (1) covered interest arbitrage (transfer of short-term funds into a foreign currency for the sake of a higher yield, with the exchange risk covered), (2) inward interest arbitrage (transfer of short-term funds into local currency for a higher yield), (3) outward interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield), and (4) uncovered interest arbitrage (transfer of short-term funds into a foreign currency for a higher yield, without covering the exchange risk).

Interest negative. The commission charged on foreign deposits on which no interest is allowed.

Interest parities. Differences at a given time between interest rates charged in two financial centers on short-term credits, investments, or time deposits of identical maturities.

Interest rate. The amount (generally expressed as a per annum percentage) of money charged for allowing another party the use of one's money.

Interest-rate cap. A transaction whereby a bank pays a fee up-front and will later receive payments if a designated interest rate exceeds a minimum threshold established in the contract. If during the contract, interest rates do not exceed the threshold, the bank loses the initial fee paid. By contrast, if interest rates exceed the threshold, a bank will receive progressively higher payments to offset higher interest expense. The payment received represents the difference between the designated rate and the threshold.

Interest-rate collar. The collar combines an interest-rate cap and a floor. A bank buys a cap and pays a fee, which protects the institution should interest rates exceed a stated threshold. The bank simultaneously sells a floor and receives a fee to offset the cost of the cap. The collar establishes a band of interest rates for liabilities—rates cannot exceed the cap's ceiling or the floor's minimum.

Interest-rate differential. The difference between the interest rates on two different currencies. Also the swap rate between two currencies expressed as a per annum percentage premium or discount.

Interest-rate floor. The floor obligates a seller to pay funds to the buyer if a specified interest rate falls below a strike rate.

Interest-rate futures. Interest-rate futures contracts offer a vehicle through which banks can shift interest-rate risk to the market for financial futures. Interest-rate futures are analogous to futures contracts on commodities. See also *Futures market*.

Interest-rate swap. A contractual obligation entered into by two parties to deliver a fixed sum of money against a variable sum of money at periodic intervals. It typically involves an exchange of payments on fixed- and floating-rate debt. If the sums involved are in different currencies, the swap is simultaneously an interest-rate swap and a currency swap.

International Banking Act of 1978 (IBA). The principal legislation pertaining to the activities of foreign banks in the United States. It established a policy of national treatment of foreign banks with regard to their operations in the United States.

International banking facility (IBF). A set of asset and liability accounts segregated on the books and records of a depository institution, U.S. branch or agency of a foreign bank, or an Edge Act or agreement corporation. 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. IBFs may receive certain tax advantages from individual states.

International Center for Settlement of Investment Disputes (ICSID). See *World Bank*.

International Lending Supervision Act (ILSA). Enacted in 1983, the act requires U.S. banking agencies to consult with bank supervisory authorities in other countries to achieve consistent policies and practices in international lending.

International Monetary Fund (IMF). A specialized agency of the United Nations, the IMF encourages monetary cooperation, promotes stable exchange policy, and makes short-term advances and standby credits to members experiencing temporary payments difficulties. Its resources come mainly from subscriptions of members.

International Money Market of the Chicago Mercantile Exchange (IMM). The IMM is one of the world's largest markets for foreign-currency and Eurodollar futures trading.

International Swap Derivatives Association

(ISDA). A trade association for derivative contracts.

Intervention. The actions of a central bank designed to influence the foreign-exchange rate of its currency. The bank can use its exchange reserves to buy its currency if it is under too much downward pressure or to sell its currency if it is under too much upward pressure.

Intracountry foreign-currency exposure. The risk that exists whenever a subsidiary or a branch lends, invests, places, or extends credit to entities that are located within the same country as the booking unit, but in a currency different from that of the country where the borrower and the booking unit are located.

Intraday position. The size of spot and forward positions allowed for a dealer during the business day, which may be larger than that allowed for the end of the date. Sometimes also called ''daylight'' limits.

Intrinsic value. The amount, if any, by which the current market price of the underlying instrument is above the exercise price for calls and below the exercise price for puts.

Issue price. The price at which a new issue of securities is placed on sale.

Joint venture. The participation of two or more entities in a single business activity. Used to facilitate entry into a market in which other forms of operation may be proscribed.

Last trading date. The final day on a futures or options exchange when trading may occur in a given futures contract month or in a given option series.

Latin American Free Trade Association (LAFTA). Originally developed to create a common market in Latin America among member countries, it has since been reorganized into the Latin American Integration Association (ALADI). Members include Argentina, Bolivia, Brazil, Chile, Colombia, Cuba, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela.

Lead manager. The commercial or investment bank with the primary responsibility for organizing a syndicated bank credit or bond issue. This includes the recruitment of additional lending or underwriting banks, the negotiation of terms with the borrower, and the assessment of market conditions.

Lending margin. The fixed percentage above the reference rate paid by a borrower in a rollover credit or on a floating-rate note.

Letter of credit—advised. An export letter of credit issued by a bank that requests another bank to advise the beneficiary that the credit has been opened in its favor. This occurs when the issuing bank does not have an office in the country of the beneficiary and uses the facilities of the advising bank. The advising bank is potentially liable only for its own error in making the notification.

Letter of credit—back-to-back. A letter of credit issued on the strength (or ''backing'') of another letter of credit, involving a related transaction and nearly identical terms. For example, ABC company in the United States is designated as the beneficiary of an irrevocable letter of credit confirmed by a U.S. bank to supply XYZ company in Bolivia, whose bank issued the letter of credit, with goods to be purchased from a third company. The third company, however, will not fill ABC's order unless it receives prepayment for the goods, either through cash or some other type of financing. If ABC is unable to prepay in cash, it will request its bank to issue a letter of credit in favor of the third company. If ABC's bank agrees, the domestic credit is then ''backed'' by the foreign letter of credit and a back-to-back letter-of-credit transaction exists.

Letter of credit—cash. A letter addressed from one bank to one or more of its correspondents that makes available to a party named in the letter a fixed sum of money up to a future specific date. The sum indicated in the letter is equal to an amount deposited in the issuing bank by the party before the letter is issued.

Letter of credit—commercial. A letter addressed by a bank, on behalf of a buyer of merchandise, to a seller authorizing the seller to draw drafts up to a stipulated amount under specified terms and undertaking conditionally or unconditionally to provide payment for drafts drawn.

- *Confirmed irrevocable letter of credit*—A letter in which a bank in addition to the issuing bank is responsible for payment.
- *Irrevocable letter of credit*—A letter in which the issuing bank waives all right to cancel or in any way amend without consent of the beneficiary or seller.
- *Revocable letter of credit*—A letter in which the issuing bank reserves the right to cancel or amend that portion of the amount that has not been demanded before the actual payment or negotiation of drafts drawn.
- *Revolving credit*—A letter in which the issuing bank notifies a seller of merchandise that the amount of credit when used will again

become available, usually under the same terms and without the issuance of another letter.

- *Special clauses—*
  - — *Green clause*—Similar to the red clause letter of credit below, except that advance payment is made, generally upon presentation of warehouse receipts evidencing storage of the goods.
  - — *Red clause*—A clause permitting the beneficiary to obtain payment in advance of shipment so that the seller may procure the goods to be shipped.
  - — *Telegraphic transfer clause*—A clause in which the issuing bank agrees to pay the invoice amount to the order of the negotiating bank upon receipt of an authenticated cablegram from the latter that the required documents have been received and are being forwarded.

Letter of credit—confirmed. A letter of credit issued by the local bank of the importer and to which a bank, usually in the country of the exporter, has added its commitment to honor drafts and documents presented in accordance with the terms of the credit. Thus, the beneficiary has the unconditional assurance that, if the issuing bank refuses to honor the draft against the credit, the confirming bank will pay (or accept) it. In many instances, the seller (exporter) may ask that the letter of credit be confirmed by another bank when the seller is not familiar with the foreign issuing bank or as a precaution against unfavorable exchange regulations, foreign-currency shortages, political upheavals, or other situations.

Letter of credit—deferred payment. A letter of credit under which the seller's draft specifies that the draft is payable at a later date, for example, 90 days after the bill-of-lading date or 90 days after presentation of the documents.

Letter of credit—export. A letter of credit opened by a bank, arising from the financing of exports from a country. The issuing bank may request another bank to confirm or advise the credit to the beneficiary. If confirmed, the credit becomes a confirmed letter of credit, and, if advised, it becomes an advised (unconfirmed) letter of credit.

Letter of credit—guaranteed. A letter of credit guaranteed by the customer (applicant) and often backed by collateral security. In domestic banks, the payment of drafts drawn under this credit is recorded in the general-ledger asset account "Customer Liability—Drafts Paid Under Guaranteed L/C."

Letter of credit—import. A letter of credit issued by a bank on behalf of a customer who is importing merchandise into a country. Issuance of an import credit carries a definite commitment by the bank to honor the beneficiary's drawings under the credit.

Letter of credit—irrevocable. A letter of credit that cannot be modified or revoked without the customer's consent or that cannot be modified or revoked without the beneficiary's consent.

Letter of credit—negotiation. A letter of credit requiring negotiation (usually in the locality of the beneficiary) on or before the expiration date. The engagement clause to honor drafts is in favor of the drawers, endorsers, or bona fide holders.

Letter of credit—nontransferable. A letter of credit that the beneficiary is not allowed to transfer in whole or in part to any party.

Letter of credit—reimbursement. A letter of credit issued by one bank and payable at a second bank that, in turn, draws on a third bank for reimbursement of the second bank's payment to the beneficiary. Those credits are generally expressed in a currency other than that of the buyer (issuing bank) or the seller, and, because of wide acceptability, many are settled in the United States through yet another bank as the reimbursing agent. Upon issuance, the correspondent sends the reimbursing bank an authorization to honor drawings presented by the negotiating bank.

Letter of credit—revocable. A letter of credit that can be modified or revoked by the issuing bank up until the time payment is made.

Letter of credit—revolving. A letter of credit issued for a specific amount that renews itself for the same amount over a given period. Usually, the unused renewable portion of the credit is cumulative as long as drafts are drawn before the expiration of the credit.

Letter of credit—standby. A letter of credit or similar arrangement, however named or described, that represents an obligation to the beneficiary on the part of the issuer—

- to repay money borrowed by or advanced to or for the account party,
- to make payment on account of any indebtedness undertaken by the account party, or
- to make payment on account of any default by the account party in the performance of an obligation.

Letter of credit—straight. A credit requiring presentation on or before the expiration date at the office of the paying bank. The engagement clause to honor drafts is in favor of the beneficiary only.

Letter of credit—transferable. A credit under which the beneficiary has the right to give instructions to the bank called upon to effect payment or acceptance to make the credit available in whole or in part to one or more third parties (second beneficiaries). The credit may be transferred only upon the express authority of the issuing bank and provided that it is expressly designated as transferable. It may be transferred in whole or in part, but may only be transferred once.

Letter of credit—traveler's. A letter of credit addressed to the issuing bank's correspondents, authorizing them to negotiate drafts drawn by the beneficiary named in the credit upon proper identification. The customer is furnished with a list of the bank's correspondents. Payments are endorsed on the reverse side of the letter of credit by the correspondent banks when they negotiate the drafts. This type of letter of credit is usually prepaid by the customer.

Letter of credit—usance. A letter of credit that calls for payment against time drafts, drafts calling for payment at some specified date in the future. Usance letters of credit allow buyers a grace period of a specified number of days, usually not longer than six months.

London Interbank Offered Rate (LIBOR). The rate at which, theoretically, banks in London place Eurocurrencies/Eurodollars with each other.

London International Financial Futures Exchange (LIFFE). A London exchange where foreign-currency and Eurodollar futures, as well as foreign-currency options, are traded on spot exchange. LIFFE was taken over by Euronext in 2002 and subsequently merged with the New York Stock Exchange in 2007.

Limits (bank customer—foreign-exchange and interbank). Maximum line amounts allowed with other banks for forward exchange transactions, Eurocurrency and Eurodollar transactions, and payments arising from foreign-exchange transactions on the same day.

Listing. The formal process required to have a security regularly quoted on an exchange. Eurobonds are usually listed so that they can be purchased by those institutional investors who are constrained to invest in listed securities.

Local-currency exposure. The amount of assets and non-balance-sheet items that are denominated in the local currency of that country.

Lock-up. The term used to refer to procedures followed in a Eurobond issue to prevent the sale of securities to U.S. investors during the period of initial distribution.

Long position. An excess of assets (and/or forward purchase contracts) over liabilities (and/or forward sale contracts) in the same currency. A dealer's position when the net purchases and net sales leave him or her in a net-purchased position.

Loro accounts. Current accounts banks hold with foreign banks in a foreign currency on behalf of their customers.

Maintenance margin. The minimum equity a futures exchange requires in a customer's account for each futures contract subsequent to deposit of the initial margin.

Managed float. See *Dirty float*.

Management fee. The fee received by lead banks as compensation for managing a large-syndicate financing.

Manager of participation. The original lender of any loan in which participations are later sold and who generally has a fiduciary relationship with the other lenders. See also *Agent bank*.

Manager of syndicate. The bank that solicits the loan from the borrower and solicits other lenders to join the syndicate making the loan.

Margin. The amount of money and/or securities that must be posted as a security bond to ensure performance on a contract.

Marine insurance. Insurance for losses arising from specified marine casualties. Marine insurance is more extensive than other types as it may provide not merely for losses arising from fire, but also from piracy, wrecks, and most injuries sustained at sea.

- *Average*—A term in marine insurance signifying loss or damage to merchandise.
- *General average*—A loss arising from a voluntary sacrifice of any portion of a shipment or cargo to prevent loss of the whole and for the benefit of all persons at interest. The value of this loss is apportioned not only among all the shippers, including those whose property is lost, but also to the vessel itself. Until the assessment is paid, a lien lies against the whole cargo.
- *Particular average*—A partial loss or damage of merchandise caused by a peril insured against and that does not constitute a general average loss.
- *Free of particular average (F.P.A.)*—Insurance against partial loss regardless of the percentage of the loss.
- *Casco insurance*—Marine insurance on the ship itself (hull) that is usually purchased by

the owners.

- *Cover note*—English equivalent of American binder.
- *Open policy*—A contract between an insurance company and a shipper by which all shipments made by the insured are automatically protected from the time the merchandise leaves the initial shipping point until delivery at destination.

Mark-to-market. The revaluation of a traded asset or commodity to reflect the most recently available market price.

Market-maker. A bank or other financial institution that gives two-sided (bid and offer) quotations. A market-maker stands prepared to do business on either side of the market without knowing if the inquiring institution intends to buy or sell.

Market order. An order that is to be executed immediately at the best available price in the market.

Matched. A forward purchase is matched when it is offset by a forward sale for the same date or vice versa. As a necessity, however, when setting limits for unmatched positions, a bank may consider a contract matched if the covering contract falls within the same week or semimonthly period.

Maturity date. The settlement date or delivery date for a forward contract.

Medium-term notes. Intermediate-term notes that carry a maturity between nine months and ten years.

Merchant bank. A European form of an investment bank.

Money market. A wholesale market for low-risk, highly liquid, short-term debt instruments.

Multicurrency line. A line of credit that gives the borrower the option of using any of the readily available major currencies.

Multilateral exchange contract. An exchange contract involving two foreign currencies against each other, for example, a contract for U.S. dollars against Swiss francs made in London or a contract for British pounds against Japanese yen made in New York. Also called an arbitrage exchange contract.

Multinational bank. A commercial bank engaged in selling services or conducting operations in more than one country.

Nationalization. The act whereby a central government assumes ownership and operation of private enterprises within its territory.

Negative interest. A fee charged by a bank for accepting a deposit from a customer. This can happen when a currency is under pressure to appreciate. A central bank in this situation can establish capital-import controls and limit the amount of deposits that a bank can receive from nonresidents. If market participants want to deposit more money in the country than the central bank will allow, interest rates will drop initially to zero and, if the pressure continues, produce negative interest. Any taxes that a central bank may impose on foreign deposits can also create negative interest.

Negative pledge. A contractual promise by a borrower in a syndicated loan or a bond issue not to undertake some future action. One typical negative pledge is that future new creditors will not be given rights greater than those of existing creditors.

Negotiable instruments. Written orders or promises to pay that may be transferred by endorsement or delivery, for example, by checks, bills of exchange, drafts, and promissory notes. Governed by article 3 of the Uniform Commercial Code.

Negotiate. (1) Letters of credit—To verify that the documents presented under a letter of credit conform to requirements and then, if the documents are in order, to pay the seller of the goods. (2) Negotiable instruments—To transfer possession of an instrument by a person other than the issuer to another person who thereby becomes its holder.

Net accessible interest differential. The difference between the interest rates that can actually be obtained on two currencies. This difference is usually the basis of the swap rate between the two currencies and, in most cases, is derived from external interest rates rather than domestic ones. These external rates, or Euro-rates, are free from reserve requirements (which would increase the interest rate) and from exchange controls (which would limit access to the money).

Net exchange position. An imbalance between all the assets and purchases of a currency, and all the liabilities and sales of that currency.

Net position. A bank has a net position in a foreign currency when its assets (including future contracts to purchase) and liabilities (including future contracts to sell) in that currency are not equal. An excess of assets over liabilities, including future contracts, is called a net “long” position, and liabilities in excess of assets result in a net “short” position. A net long position in a currency that is depreciating results in a loss because, with each day, the position is convertible into fewer units of local currency. A net short position in a currency that is appreciating represents a loss because, with each day, satisfaction of the position costs more units of local currency.

Netting arrangement. Agreement by two counterparties to examine all contracts settling in the same currency on the same day and to agree to exchange only the net currency amounts. Also applies to net market values of several contracts.

Nominal interest rate. The interest rate stated as a percentage of the face value of a loan. Depending on the frequency of interest collection over the life of the loan, the nominal rate may differ from the effective interest rate.

Nonrevolving. A line of credit that cannot be reused once it has been drawn down to a specified amount.

Nostro accounts. Demand accounts of banks with their correspondents in foreign countries in the currency of that country. These accounts are used to make and receive payments in foreign currencies for a bank's customers and to settle maturing foreign-exchange contracts. Also called due from foreign bank—demand accounts, our balances with them, or due from balances.

Novation. The substitution of a new party for one of the original parties to a contract. The result is a new contract with the same terms, but at least one new party.

Odd dates. Deals within the market are usually for spot, one month, two months, three months, or six months forward. Other dates are odd dates, and prices for them are frequently adjusted with more than a mathematical difference. Hence, most market deals are for regular dates, although commercial deals for odd dates are common.

Offer rate. The price at which a quoting party is prepared to sell or lend currency. This is the same price at which the party to whom the rate is quoted will buy or borrow if it desires to do business with the quoting party. The opposite transactions take place at the bid rate.

Offering circular. A document giving a description of a new securities issue, as well as a description of the entity making the issue.

Office of Foreign Asset Control (OFAC). An office within the U.S. Treasury Department that administers U.S. laws imposing economic sanctions against targeted hostile foreign countries. While OFAC is responsible for administration of these statutes, all of the bank regulatory agencies cooperate in ensuring compliance.

Official rate. The rate established by a country at which it permits conversion of its currency into that of other countries.

Offshore branch. Banking organization designed to take advantage of favorable regulatory or tax environments in another country. Many of these operations are shell branches with no physical presence.

Offshore dollars. The same as Eurodollars, but encompassing the deposits held in banks and branches anywhere outside of the United States, including Europe.

Open contracts (open positions). The difference between long positions and short positions in a foreign currency or between the total of long and short positions in all foreign currencies. Open spot or open forward positions that have not been covered with offsetting transactions. See also *Net position*.

Open interest. The total number of futures contracts for a particular asset that have not been liquidated by an offsetting trade or that have not been fulfilled by delivery.

Open market operations. Purchases or sales of securities or other assets by a central bank on the open market.

Open position limit. A limit placed on the size of the open position in each currency to manage off-balance-sheet items.

Opening bank. The bank that draws up and opens the letter of credit and that makes payment according to the conditions stipulated.

Option contract. A contract giving the purchaser the right, but not the obligation, to buy (call option) or sell (put option) an asset at a stated price (strike or exercise price) on a stated date (European option) or at any time before a stated date (American option).

Organisation for Economic Co-operation and Development (OECD). Founded as a successor organization to the Organization for European Economic Cooperation (OEEC). The OEEC was originally established to administer aid under the Marshall Plan during the post-World War II period. The goals of the successor OECD are to stimulate world trade, economic growth, and economic development. Members include Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States.

Organization of American States (OAS). An organization of 35 independent states of the Americas formed to promote intergovernmental cooperation in the Western Hemisphere.

Organization of the Petroleum Exporting Countries (OPEC). A federation of oil-exporting countries that sets petroleum prices for member countries. Members include Algeria, Angola, Ecuador, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela.

Out-of-the-money. A term used to refer to a call option whose strike price is above or to a put option whose strike price is below the current price of the asset on which the option is written.

Outright. Forward exchange bought and sold independently from a simultaneous sale or purchase of spot exchange.

Outright forward rate. A forward exchange rate that is expressed in terms of the actual price of one currency against another, rather than, as is customary, by the swap rate. The outright forward rate can be calculated by adding the swap premium to the spot rate or by subtracting the swap discount from the spot rate.

Overbought. The position of a trader who has bought a larger amount of a commodity or asset than he or she has sold.

Overnight. A swap transaction involving same-day settlement of the spot transaction against a value date of the next business day on the forward contract.

Overnight position. A foreign-exchange or money market position maintained overnight. There is more risk involved in this position than in one maintained during the day because political and economic events may take place at night when the operator cannot react immediately to them.

Override limit. The total amount of money (measured in terms of a bank's domestic currency) that the bank is willing to commit to all foreign-exchange net positions.

Oversold. The position of a trader who has sold a larger amount of a certain asset or commodity than he or she has bought.

Over-the-counter (OTC). Transactions not conducted in an organized exchange. OTC markets have no fixed location or listing of products.

Paris Club. An ad hoc group of western creditor governments that meets informally under the chairmanship of the French Treasury. Its function is to start the process of rescheduling a country's official debt.

Parity. A term derived from par, meaning the equivalent price for a certain currency or security relative to another currency or security, or relative to another market for the currency or security after making adjustments for exchange rates, loss of interest, and other factors.

Parity grid. The system of fixed bilateral par values in the European Monetary System. The central banks of the countries whose currencies are involved in an exchange rate are supposed to intervene in the foreign-exchange market to maintain market rates within a set range defined by an upper and a lower band around the par value.

Participation. The act of taking part in a syndicated credit or a bond issue.

Par value. The official parity value of a currency relative to the dollar, gold, Special Drawing Rights, or another currency.

Paying agent. A bank or syndicate of banks responsible for paying the interest and principal of a bond issue to bondholders on behalf of the bond issuer.

Performance bond. A bond supplied by one party to protect another against loss in the event of the default of an existing contract.

Placement memorandum. A document in a syndicated Eurocredit that sets out details of the proposed loan and gives information about the borrower.

Political risk. Political changes or trends, often accompanied by shifts in economic policy, that may affect the availability of foreign exchange to finance private or public external obligations. The banker must understand the subtleties of current exchange procedures and restrictions, as well as the possibilities of war, revolution, or expropriation in each country with which the bank transacts business, regardless of the actual currencies involved. See also *Country Risk.*

Portfolio investment. An investment in an organization, other than a subsidiary or joint venture, in which less than 20 percent of the voting shares are held.

Position. A situation created through foreign-exchange contracts or money market contracts in which changes in exchange rates or interest rates could create profits or losses for the operator.

Position book. A detailed, ongoing record of an institution's dealings in a particular foreign currency or money market instrument.

Position risk. See *Net position*.

Position-trader. A speculator in the futures market who takes a position in the market for a period of time.

Premium. The adjustment to a spot price that is made in arriving at a quote for future delivery. If a dealer were to quote $2.00 and $2.05 (bid and asked) for sterling, and the premiums for six months forward are 0.0275 and 0.0300, the forward quotes would be adjusted to $2.0275 and $2.0800. The premium usually represents differences in interest rates for comparable instruments in two countries. However, in periods of crisis for a currency, the premium may represent the market anticipation of a higher price.

Price quotation system. A method of giving exchange rates in which a certain specified amount of a foreign currency (1 or 100, usually) is stated as the corresponding amount in local currency.

Primary dealers. Securities firms that are recognized by the Federal Reserve System to buy and sell securities with the Fed.

Private placement. The process of negotiating for the sale of securities, debt, equity, or a combination thereof to a relatively small group of investors.

Protest. The formal legal process of demanding payment of a negotiable item from the maker or drawee who has refused to pay.

Public Law (P.L.) 480. The most common reference to the Agricultural Trade Development and Assistance Act of 1954. Generally, P.L. 480 authorizes the President to provide various types of assistance to American agricultural exporters, such as making sales in the currency of the destination country.

Put. The ability of the bank to require repayment of the debt of a borrower by a third party because of nonperformance of the borrower through an agreement other than a formal guarantee.

Put option. A contract giving the purchaser the right, but not the obligation, to sell a particular asset at a stated strike price on or before a stated date.

Rate risk. In the money market, the chance that interest rates may rise when an operator has a negative money market gap (a short position) or that interest rates may go down when the operator has a positive money market gap (a long position). In the exchange market, the chance that the spot rate may rise when the trader has a net oversold position (a short position), or that the spot rate may go down when the operator has a net overbought position (a long position).

Rate swap. A transaction in which one participant pays a fixed rate of interest on a notional amount for a given period of time and the other pays a floating rate.

Reciprocal rate. The price of one currency in terms of a second currency, when the price of the second currency is given in terms of the first.

Recourse. The ability to pursue judgment for a default on a negotiable instrument against parties who signed the note.

Representations. Statements made by a borrower in a syndicated credit or bond issue describing the borrower's financial condition.

Representative office. A facility established in U.S. or foreign markets by a bank to sell its services and assist clients; in the United States, these offices cannot accept deposits or make loans.

Repurchase agreement (repo or RP). A holder of assets sells those assets to an investor with an agreement to repurchase them at a fixed price on a fixed date. The security "buyer" in effect lends the "seller" money for the period of the agreement, and the terms of the agreement are structured to compensate the buyer for this. Dealers use repo extensively to finance their positions.

Reserve account. Those items in the balance of payments that measure changes in the central bank's holdings of foreign assets (such as gold, convertible securities, or Special Drawing Rights).

Reserve currency. A foreign currency held by a central bank (or exchange authority) for the purposes of exchange intervention or the settlement of intergovernmental claims.

Reserve requirements. Obligations imposed on commercial banks to maintain a certain percentage of deposits with the central bank or in the form of central-bank liabilities.

Retiming. Restructuring of the timing of interest payable on bonds.

Revaluation. An official act wherein the parity of a currency is adjusted relative to the dollar, gold, Special Drawing Rights, or another currency, resulting in less revalued units relative to those currencies. (See also *Devaluation*.) Also, the periodic computations of the current values (revaluations) of ledger accounts and unmatured future purchase and sales contracts.

Revolving credit. A line of bank credit that may be used at the borrower's discretion. Interest is paid on the amount of credit actually in use, while a commitment fee is paid on the unused portion.

Revolving into term. A commitment that allows a revolving line of credit (usually one to three years) with term provision at the expiration of the revolver for an additional period of time. Most common is a two-year revolver with a five-year, fully amortizing term portion.

Revolving line of credit. A line of credit that permits successive drawings and payments at the borrower's discretion. The funds available to the borrower are replenished by any payments of principal.

Risk-management tools. Financial devices (such as futures or options) that permit a borrower or lender of funds to protect against the risks of changing currency prices and/or interest rates.

Risk participation. An agreement whereby a bank shares the risk in an outstanding credit or instrument. Credit-equivalent amounts of risk participations are assigned based on the risk category appropriate to the account party obligor or, if relevant, to the nature of the collateral or guarantees. Usually treated as a direct credit substitute.

Rollover. The process of selling new securities to pay off old ones coming due, refinancing an existing loan, or extending a maturing forward foreign-exchange contract.

Rollover credit. A bank loan with an interest rate periodically updated to reflect market interest rates. The interest rate in the loan for each subperiod is specified as the sum of a reference rate and a lending margin.

Rollover date. The end of an interest period in a revolving term loan.

Same-day funds. Federal funds, or the equivalent, used in the settlement of a transaction that will probably create an interest adjustment of the trading rate to compensate for the difference in the availability of the funds for use.

Samurai bonds. Yen-denominated bonds issued by a foreign borrower in Japan.

Scalpers. Floor or pit traders in the futures market with short-term horizons who sell slightly above the most recent trade and buy at a price slightly below.

Seasoned securities. Securities that have traded in the secondary market for more than 90 days.

Secondary market. A market in which securities are traded following the time of their original issue.

Selling concession. The share of total investment-banking fees accruing to the selling group.

Selling group. All banks involved in selling or marketing a new issue of bonds. Sometimes the term is used in reference to dealers acting only as sellers and is intended to exclude reference to underwriters or managers.

Seller's option contract. A contract in which the seller has the right to settle a forward contract at his or her option anytime within a specified period. See also *Option contract*.

Selling rates. Rates at which dealers are prepared to sell foreign exchange in the market.

Settlement day. The day on which the actual transfer of two currencies or the transfer of money for an asset takes place at a previously arranged price.

Settlement price. The official daily closing price for a futures or option contract. This price is established and used by a clearinghouse to determine each clearing firm's settlement variation.

Settlement risk. The possibility that a seller of foreign exchange or securities, having collected the payment in local currency, may fail to deliver the exchange or securities to the buyer.

Settlement variation. The sum of all changes in amount for each of a firm's futures or options positions as calculated from each day's settlement price. This amount is paid to or received from the clearinghouse each day based on the previous day's trading.

Shell branch. See *Offshore branch*.

Shogun bonds. Foreign bonds issued in Tokyo and denominated in currencies other than the Japanese yen. The usual denomination is the U.S. dollar.

Short position. An excess of liabilities (and/or forward sale contracts) over assets (and/or forward purchase contracts) in the same currency. A dealer's position when the net of purchases and sales leaves the trader in a net-sold or oversold position.

Sight draft. A draft payable upon presentation to the drawee or within a brief period thereafter known as "days of grace."

Society for Worldwide Interbank Financial Telecommunications (SWIFT). A telecommunications network established by major financial institutions to facilitate messages among SWIFT participants. These messages typically result in a monetary transaction between institutions. The network is based in Brussels.

Soft currency. A currency that is not freely convertible into other currencies.

Soft loans. Loans with exceptionally lenient repayment terms, such as low interest, extended amortization, or the right to repay in the currency of the borrower.

Sole of exchange. A phrase appearing on a draft to indicate that no duplicate is being presented.

Sovereign risk. The risk that the government of a country may interfere with the repayment of debt.

Space arbitrage. The buying of a foreign currency in one market and the selling of it for a profit in another market.

Special Drawing Rights (SDRs). International paper money created and distributed to governments by the IMF in quantities dictated by special agreements among its member countries. The value of SDRs is determined by the weighted value of a ‘‘basket’’ of major currencies.

Specially designated nationals. Persons or entities listed by OFAC. These persons or entities are typically front organizations and are subject to OFAC prohibitions. See also *Blocked account, Office of Foreign Asset Control*.

Speculation. The purchase or sale of a trading unit, usually on a forward basis, in hopes of making a profit at a later date. The term is used in the foreign-exchange, commodity, stock, and option markets.

Spot contract. A foreign-exchange contract traded in the interbank market in which the value date is two business days from the trade date.

Spot exchange (or spot currency). Foreign exchange purchased or sold for immediate delivery and paid for on the day of the delivery. Immediate delivery is usually considered delivery in one to two business days after the conclusion of the transaction. Many U.S. banks consider transactions maturing in as many as ten business days as spot exchange. Their reasons vary but are generally to facilitate revaluation accounting policies and to initiate final confirmation and settlement verification procedures on future contracts nearing maturity. See also *Futures (or forward) exchange contract*.

Spot month. The futures-contract month that is also the current calendar month.

Spot/next. In the foreign-exchange market, a term used to describe a swap transaction for value on the spot date with the reverse transaction taking place the next working day after the spot date. In the Eurocurrency market, a term used to describe a loan or deposit for value on the spot date with maturity on the next working day after the spot date.

Spot transaction. A transaction for spot exchange or currency.

Spread. The difference between the bid rate and the offer rate in an exchange-rate quotation or an interest quotation. This difference is not identical with the profit margin because traders seldom buy and sell at their bid and offer rates at the same time. In another sense (for example, Eurodollar loans priced at a mark-up over LIBOR), spread means a mark-up over cost, and, in this context, the spread is identical with the profit margin.

Square exchange position (or square-off). To make the inflows of a given currency equal to the outflows of that currency for all maturity dates. This produces a square exchange position in that currency.

Stabilization. The efforts by a lead manager in a securities issue to regulate the price at which securities trade in the secondary market, during the period that the securities syndicate is still in existence.

Sterilization. Intervention in the foreign-exchange market by a central bank in which the change in the monetary base caused by the foreign-exchange intervention is offset by open market operations involving domestic assets.

Straight bill of lading. A bill of lading drawn directly to the consignee and therefore not negotiable. See also *Bill of lading*.

Strike price. The price at which an option buyer may purchase (if a call option) or sell (if a put option) the asset upon which the option is written.

Subscription agreement. An agreement between a securities issuer and the managing banks that describes the terms and conditions of the issue and the obligation of the parties to the agreement.

Subscription period. The time period between the day on which a new securities issue is announced and the day on which the terms of the issue are signed and the securities are formally offered for sale.

Subsidiary. Entity in which a bank has a modicum of control. Used to facilitate entry into foreign markets in which other operations are proscribed.

Sushi bonds. Dollar-denominated Eurobonds issued by Japanese companies and purchased primarily by Japanese investors. These bond issues are typically managed by Japanese banks.

Swap. The combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. The trading of one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. See also *Swap cost (or profit)*.

Swap arrangement—reciprocal. A bilateral agreement between central banks enabling each party to initiate swap transactions up to an agreed limit to gain temporary possession of the other party's currency.

Swap cost (or profit). In a swap transaction, the cost or profit related to the temporary movement of funds into another currency and back again. That exchange cost or profit must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. Furthermore, the true trading profits or losses generated by the foreign-exchange trader cannot be determined if swap profits or costs are charged to the exchange function rather than allocated to the department whose loans or investments the swap actually funded.

Swap and deposit. A combination of swap transactions that enables the borrower to have use of both currencies for the duration of the transaction.

Swap position. A situation in which the scheduled inflows of a given currency are equal to the scheduled outflows, but the maturities of those flows are purposely mismatched. The expectation in a swap position is that the swap rate will change and that the gap can be closed at a profit.

Swap rate. The difference between the spot exchange rate of a given currency and its forward exchange rate.

Swap-swap. A swap transaction involving one forward maturity date against another forward maturity date.

Swaption. An option on a swap. It gives the buyer the right, but not the obligation, to enter into an interest-rate swap at a future period of time.

Syndicate. A group of banks that acts jointly, on a temporary basis, to loan money in a bank credit (syndicated credit) or to underwrite a new issue of bonds (bond underwriting syndicate).

Syndicate leader. See *Manager of syndicate*.

Syndicate participation. Usually, a large credit arranged by a group of lenders, each of whom advances a portion of the required funds. It differs from a participation loan because the banks participate at the outset and are known to the borrower.

Take-down. The receipt of the principal of a loan by the borrower.

Tariff. A duty or tax on imports that can be either a percentage of cost or a specific amount per unit of import.

Telegraphic transfer (TT) rate. The basic rate at which banks buy and sell foreign exchange. Buying rates for mail transfers, foreign-currency drafts, traveler's checks, and similar instruments are all based on the TT rate. The TT rate may be slightly less favorable than other rates because of the time required for collection. Foreign-currency time (usance) drafts also are bought at the TT rate, but interest to maturity is deducted for the time which must elapse until maturity.

Telex. Direct communication between two banks or companies and organizations via satellite or underwater cable.

Tenor. A term designating payment of a draft as being due at sight, a given number of days after sight, or a given number of days after the date of the draft.

Term structure. The level of interest rates on debt instruments of a particular type, viewed as a function of term to maturity. The interest-rate level may rise or fall with increasing maturity.

Terms of trade. Relative price levels of goods exported and imported by a country.

Test key. A code used in transferring funds by cable or telephone so that the recipient may authenticate the message. A test key generally consists of a series of numbers, including a fixed number for each correspondent bank; a number for the type of currency; a number for the total amount; and, possibly, numbers for the day of the month and day of the week. A single number code indicates whether the total amount is in thousands, hundreds, tens, or digits. To arrive at a test number, the indicated numbers are totaled, and the total amount usually precedes the text of the message.

Third-country bills. Banker's acceptances issued by banks in one country that finance the transport or storage of goods traded between two other countries.

Tied loan. A loan made by a governmental agency that requires the borrower to spend the proceeds in the lender's country.

Time draft. A draft drawn to mature at a fixed time after presentation or acceptance.

Time value. The amount by which an option's market value exceeds its intrinsic value.

Tombstone. In a syndicated credit, an advertisement placed in a newspaper or magazine by banks to record their participation in the loan or, in a bond issue, to record their role in managing, underwriting, or placing the bonds.

Tomorrow next (tom/next). The simultaneous purchase and sale of a currency for receipt and payment on the next and second business day, respectively, or vice versa.

Tradable amount. The minimum amount accepted by a foreign-exchange broker for the interbank market, for example, 100,000 Canadian dollars or 50,000 pounds sterling.

Trade acceptance. A draft drawn by the seller (drawer) on the buyer (drawee) and accepted by the buyer. Also called a trade bill, customer acceptance, and two-name trade paper. See also *Acceptance*.

Trade accounts. Those parts of the balance of payments that reflect money spent abroad by the citizens of a country on goods and services and the money spent by foreigners in the given country for goods and services.

Trader's (or dealer's) ticket (slip). The handwritten record of a foreign-exchange trade and/or placing and taking of deposits that is written by the dealer who executed the transaction.

Trading position worksheet. A record of incomplete transactions in a particular currency.

Tranche. One of a number of drawings of funds made by a borrower under a term loan.

Transaction date. The date on which a contract's terms are negotiated and agreed on.

Transfer risk. The risk arising when a borrower incurs a liability in a currency that is not the currency in which revenues are generated. The borrower may not be able to convert its local currency to service an international loan if foreign exchange is not generated.

Trending of rates. Quoting a slightly higher or lower two-way rate in order to reflect a preference for either purchasing or selling.

Trust receipt. Used extensively in letter-of-credit financing, this is a document or receipt in which the buyer promises to hold the property received in the name of the releasing bank, although the bank retains title to the goods. The merchant is called the trustee, the bank the entruster. Trust receipts are used primarily to allow an importer to take possession of the goods for resale before payment to the issuing bank.

Two-way quotation. A simultaneous quotation of foreign-exchange buying and selling rates implying the willingness of the bank to deal either way.

Two-way rate. An exchange-rate or an interest-rate quotation that contains both a bid rate and an offer rate. The size of the spread between the two rates indicates the relative quality of the quotation.

Unconfirmed letter of credit. See *Letter of credit—advised*.

Undervalued. Decline of the spot rate below purchasing power parities, so that the goods of one county are cheaper than in another country. In relation to forward exchange, "undervalued" means that forward premiums are narrower or forward discounts are wider than the interest parities between the two financial centers.

Underwriting allowance. The share of total investment-banking fees accruing to the underwriting group.

Underwriting syndicate. The banks, in a new securities issue, that agree to pay a minimum price to the borrower even if the securities cannot be sold on the market at a higher price.

Uniform customs and practices for documentary credits. Sets of rules governing documentary letters of credit formulated by the International Chamber of Commerce. Includes general provisions, definitions, forms, responsibilities, documents, and the transfer of documentary letters of credit.

Unmatched. A forward purchase is unmatched when a forward sale for the same date has not been executed or vice versa.

Unmatured transactions. Trading transactions that have not reached their settlement dates.

Usance. The period of time between presentation of a draft and its maturity. See also *Tenor*.

Value-compensated. The payment or collection of a settlement cost on an open forward contract to cancel the contract rather than to execute an offsetting contract for the same maturity date.

Value date. The date on which foreign exchange bought and sold must be delivered and on which the price for the exchange must be paid.

Value-impaired. A category assigned by the Interagency Country Exposure Review Committee that indicates a country has protracted debt problems.

Value today. An arrangement by which spot exchange must be delivered and paid for on the day of the transaction instead of two business days later.

Value tomorrow. An arrangement by which spot exchange must be delivered and paid for on the business day following the transaction instead of two business days after the transaction.

Variation margins. Positive or negative changes in the value of a security bought on margin or a futures contract. These variations must be paid daily in cash. All securities bought or sold on margin and futures contracts are marked to market.

Volatility. The standard deviation of changes in the logarithm of an asset price, expressed at a yearly rate. The volatility is a variable that appears in option formulas.

Volume quotation system. A method of giving exchange rates in which a certain specified amount of local currency (usually 1 or 100) is stated as the corresponding amount in foreign currency.

Vostro account. A demand account maintained for a bank by a correspondent bank in a foreign country. The nostro account of one bank is the vostro account of the other bank. See also *Nostro account*.

Warehouse receipt. An instrument that lists and is a receipt for goods or commodities deposited in the warehouse that issues the receipt. These receipts may be negotiable or non-negotiable. A negotiable warehouse receipt is made to the "bearer," while a nonnegotiable warehouse receipt specifies precisely to whom the goods shall be delivered. There are several alternatives for releasing goods held under warehouse receipts: (1) the delivery of goods may be allowed only against cash payment or substitution of similar collateral; (2) some or all of the goods may be released against the trust receipt without payment, or (3) a warehouseman may release a stipulated quantity of goods without a specific delivery order. Banks will accept a warehouse receipt as collateral for a loan only if the issuer of a receipt is a bonded warehouseman. The bank must have protected assurances for the authenticity of the receipt and the fact that the commodities pledged are fully available as listed on the warehouse receipt.

Wash. A transaction that produces neither profit nor loss.

Wire. Often the words "wire" and "cable" are used interchangeably. In some cases, "wire" denotes messages sent within the confines of the United States, and "cable" refers to messages transmitted overseas. Others use "wire" to mean a transfer of funds by telephone rather than by cable, telex, or telegram.

Withholding tax. A tax imposed by a country on the gross amount of payments to a foreign lender from an in-country borrower.

Within-line facility (or facilities). Subfacilities of the line of credit that establish parameters, terms, and conditions of various other facilities available for specific additional purposes or transactions. The aggregate sum of all outstandings under within-line facilities must not exceed the total of the overall line of credit.

World Bank (The International Bank for Reconstruction and Development). An international financial organization whose purpose is to aid the development of productive facilities in member countries, particularly in developing countries. The chief source of funds is capital contributions made by member countries, which vary with the financial strength of the country. Another funding source is the sale of long-term bonds.

Writer. An individual who issues an option and, consequently, has the obligation to sell the asset (if the option is a call) or to buy the asset (if the option is a put) on which the option is written if the option buyer exercises the option.

Yankee bond. A dollar-denominated foreign bond issued in the U.S. market.

Yield curve. The interest rates for each different tenor or maturity of a financial instrument. A graph of the yield curve has interest rates on the vertical axis and time-to-maturity on the horizontal axis. When longer maturities have higher interest rates than shorter maturities, the curve is called a positive or upward-sloping yield curve. The opposite type of curve is called a negative, downward-sloping, or inverted yield curve. When interest rates are the same for all maturities, the curve is called a flat yield curve. See also *Term structure*.

Yield to maturity. The rate of interest on a bond when calculated as that rate of interest which, if applied uniformly to future time periods, sets the discounted value of future bond coupon and principal payments equal to the current market price of the bond.

Zero coupon bond. A bond that pays no interest but that is redeemed at its face value at maturity.

Although the methods of international loan portfolio management are similar to those established for domestic lending, the additional risks in international lending require specialized expertise and careful management by the bank. Banks conducting international lending activities should establish strong policies that include not only the basic components found in domestic policies but also the following segments.

Geographic limits. The bank should delineate those countries or geographic areas where it can lend profitably and soundly in accordance with its objectives and in consideration of country risks. International lending officers must know the specific country limits established by the board of directors, and the bank should have a monitoring system to ensure adherence to those limits. The limits established will depend on each bank's available financial resources, the qualifications and skills of its staff, the extent of its lending activities, and its further growth potential.

Distribution by category. Limitations based on aggregate percentages of total international loans in real estate, consumer credit, ship financing, or other categories are common. Although loan distribution policy may differ among banks, international loans are generally granted in the following categories:

- import and export financing
- loans to corporations or their overseas branches, subsidiaries, or affiliates with a parent guarantee or other form of support
- loans granted to foreign local borrowers including foreign entities of U.S. concerns that borrow without any form of support from the parent corporation
- loans and placements to foreign banks or to overseas branches of U.S. banks
- loans to foreign governments or foreign governmental entities

The categories of credit extensions that the bank's international division should engage in and the nature of any limitations will depend on the particular bank and its customers. Deviations from policy limitations that have been approved by the board of directors or its designated committee(s) should be allowed to meet the changing requirements of the bank's customers. During times of heavy loan demand in one category, an inflexible loan distribution policy could cause that category to be slighted in favor of another.

Types of credits. The lending policy should state the types of international credits that the bank can make and set guidelines to follow in granting specific credits. The decision about the types of credits to be granted should be based on consideration of the expertise of the lending officers, deposit structure of the bank, and anticipated credit needs of its customers. Complex credits requiring more than normal policing should be avoided unless or until the bank obtains the necessary personnel to administer those credits properly. Types of credit that have resulted in an abnormal loss to the bank's international division should be controlled or avoided within the framework of stated policy. Syndications and other types of term loans should be limited to a given percentage of the bank's stable funds.

Maximum maturities. International credits should be granted with realistic repayment plans. Maturity scheduling should be related to the anticipated source of repayment, the purpose of the credit, the useful life of the collateral, and the degree of country risk. For term loans, a lending policy should state the maximum number of months during which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and modifications to the original terms of a loan. If the bank requires a cleanup (out-of-debt) period for lines of credit, that period should be explicitly stated.

Loan pricing. Interest rates, fees, commissions, and discounts on various loan types established by the loan policy must be sufficient to cover the costs of funds loaned, servicing of the loan (including general overhead), and probable losses, while providing for a reasonable rate of return. Periodic review allows the rates to be adjusted to account for changes in costs and competitive factors. Additionally, the bank must establish practices to ensure a continuous examination of the relationships between loan pricing and the cost of funds.

Foreign-exchange risks. Lending policy should include controls that minimize risks for loan portfolios in one currency funded by borrowings in another. These activities must be identified and should be limited by the bank if—

- a particular foreign government is expected to impose stringent exchange controls;
- the currencies involved are or will be subject to wide exchange-rate fluctuations; or
- political, social, or economic developments are likely to intensify exchange risks.

Multicurrency credit commitments permit borrowers to select from a specific list of currencies the one they prefer to use in each rollover period. The listed currencies, however, may be unavailable or available only at a high cost. The bank should protect itself by stating in the loan agreement that its requirement to provide any of the currencies listed is subject to availability at the time requested by the borrower. For detailed information on foreign-exchange risks, see section 7100, ''International—Foreign Exchange.''

Documentation and collateral. Trade financing often represents a significant amount of an international division's lending activity. In this type of financing, the bank deals only in documents, while its customer is responsible for the merchandise under the terms of the sales contract. The bank's control of documents, especially title documents, is crucial. Lending officers and applicable personnel, therefore, must be knowledgeable in handling documentation, which may be the bank's ultimate support for certain transactions.

The bank must establish policies for taking overseas collateral as security for a loan to ensure that local required procedures are met. For example, in many countries, liens on fixed assets must be registered with the local government, depending on the type of asset. Lending against current assets also requires special care and monitoring. The bank must know which countries do not recognize the legality of trust receipts as recognized in the United States. In other countries, borrowers sign powers of attorney or similar documents permitting lenders to take specifically defined collateral at any time. For these and other reasons, the bank must retain local lawyers who are thoroughly familiar with that country's laws, regulations, and practices and who will check loan agreements, guarantees, debt instruments, drafts, corporate resolutions, and other loan documentation. There are significant differences between loan agreements drawn in the United States and those drawn abroad. Nevertheless, the bank must ensure that its loan agreements with borrowers protect it adequately. Generally, few restrictive covenants are required for international loans because of competition in offshore markets and differing local practices. Nevertheless, the bank should insist on protective covenants when appropriate, especially if the borrowers are small or medium-sized obligors. The bank also should ensure that loan agreements provide for the borrower to reimburse the lender for certain unanticipated costs, including the imposition of taxes on interest withheld at the source without corresponding credits gained on the levy of U.S. taxes and the need to establish or increase bad debt reserves.

Financial information. Current and complete financial information is necessary at the inception and throughout the term of an international loan. The lending policy should specifically define financial-statement requirements for businesses, foreign banks, foreign governments, other foreign public-sector entities, and individuals, and it should include criteria for the requirement of audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements. The requirements should be defined clearly enough so that any credit data exception in the examination report is a clear exception to the bank's lending policy.

The reliability of financial statements and accompanying information differs greatly among countries. In some countries, accounting standards and traditions are lax and audited statements are virtually unknown. Financial information provided for tax-collection purposes in foreign countries may differ from that given in confidence to the bank to obtain credit.

In analyzing financial statements of foreign entities, factors are present that do not exist when analyzing those of U.S. enterprises, such as markedly different accounting concepts, the wide use of ''hidden reserves,'' translation problems, different methods of valuing assets, or unfamiliar and sharply different legal principles. A general rule in analyzing local currency statements is not to translate figures to U.S. dollar equivalents. Fluctuating exchange rates can have a significant impact on the analysis of U.S. dollar equivalents over a period of time. If a loan is to be repaid in currency other than the borrower's domestic currency, an analysis of probable future foreign-exchange-rate movements is necessary to assess the borrower's ability to generate sufficient local currency to buy the necessary exchange. An analysis of the availability of exchange is also required to ensure full repayment at maturity. Financial Accounting Standards Board Statement No. 52, "Foreign-Currency Translation," takes certain translation adjustments out of earnings and places them in a separate component of equity capital ("foreign-currency translation adjustments"), thereby reducing the fluctuations in earnings produced by changing exchange rates. Since the financial information provided is not always reliable, the bank's policies should enable it to determine by other means the capacity, integrity, experience, and reputation of the foreign borrower.

Extensions of credit to foreign banks constitute an important segment of an international division's foreign loans. It is important to obtain information on the nature of the bank's business; its assets, liabilities, and contingent accounts; and its record of past earnings. A review of these data should lead to a determination of the strength of the bank and its ability to meet its obligations in the foreseeable future. At minimum, this review should include—

- the size and liquidity of primary and secondary reserves;
- the nature of lending activities, including types and terms of loans, extent of collateral held, and loss experience;
- lending policies and controls in effect to ensure compliance with applicable lending laws and regulations;
- the size and character of investments;
- the size of fixed assets;
- the size and nature of investments in subsidiaries and other affiliates and the extent to which the bank will support those entities in times of difficulty;
- the source and nature of deposits and their volatility;
- the nature and extent of other liabilities and contingent liabilities, including standby facilities;
- the earnings and dividend record and the adequacy of capital;
- the activities of the bank in the foreign-exchange and interbank markets;
- the size and character of the bank's international business; and
- the competency of management.

The quality of management is the key to the analysis of foreign banks and is best determined by frequent visits by officers of the lending bank. Credit checks from other lenders should be required with periodic updates. Credit reports are not available in all countries and, when provided, are often incomplete or vague. Consequently, there is no substitute for firsthand information obtained from visits to overseas banks.

Country risk. Balance of payments; exchange control; and economic, political, and social information on each borrower's home country should be on file to enable the bank to assess the elements of country risk. The lack of this information is as serious a weakness as the lack of financial information on the borrowers. For additional information, see section 7040, "International—Transfer Risk."

Limits and guidelines for purchasing loans. Purchasing loans from dealers or correspondent banks is a common practice in banks with limited opportunities to generate international credit extensions on their own. However, these purchases may restrict a bank to low-profit loans at narrow spreads over a medium-to long-term period. Buying loans seldom builds relationships with borrowers since the relationship generally stays with the bank originating the loan. Therefore, the lending policy should limit the amount of paper purchased from any one outside source and should state an aggregate limit on all these loans.

Limitation on aggregate outstanding loans. Limitations on the total amount of loans outstanding relative to other balance-sheet accounts should be established for the bank, with limits (or sublimits) applicable to international loans clearly defined. Controls over the international loan portfolio are usually expressed relative to deposits, capital structure, or total assets.

Concentration of credits. The same types of concentrations of credits found in a domestic loan portfolio may exist in the international portfolio. In international banking, however, an additional concentration involves loans to a foreign government, its agencies, and its majority-owned or -controlled entities. Loans to specific private businesses may be included in those concentrations if an interrelationship exists in the form of guarantees, moral commitments, significant subsidies, or other factors indicating dependence on the government. The bank's directorate should evaluate the risks involved in various concentrations and determine those concentrations that should be avoided or limited. The lending policy should also require that all concentrations in the international division be reviewed and reported frequently. For a full discussion of this component, see section 2050, "Concentrations of Credits."

Loan authority. The lending policy should establish written limits for all international lending officers. Lending limits also may be established for group authority, allowing a combination of officers or a committee to approve loans larger than those the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined. If the bank operates foreign branches, head office–delegated lending authority should be clearly defined and understood by overseas lending officers.

Nonperforming credits and charge-offs. The lending policy should define nonperforming credit extensions of all types (delinquencies, nonaccruals, or reduced rates) and should specify their accounting and reporting requirements. Reports should be submitted regularly to the board of directors and senior management. The management of banks with overseas branches must take extra care to define and communicate their banks' policies and procedures on nonperforming credits to ensure that all bank offices are properly identifying, accounting for, and reporting credits. The reports should include sufficient detail to allow for the determination of risk factors, loss potentials, and alternative courses of action to effect repayment of nonperforming credits. The policy governing delinquent credits should require a follow-up notice procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by senior management or the directorate for potential charge-off at a stated period of delinquency.

Other. The lending policy should be supplemented with other written guidelines for specific departments concerned with credit extensions, such as letters of credit, banker's acceptances, and discounted trade bills. Written policies and procedures approved and enforced in those departments should be referenced in the general lending policy of the bank.

Before a bank grants international credit, its objectives, policies, and practices must be clearly established. The bank must consider its overall size, financial resources, the nature of its customers, its geographic location, and the qualifications and skills of its staff. An examiner should review policies and practices to determine if they are clearly defined and adequate to monitor the condition of the portfolio. If written guidelines do not exist, there is a major deficiency in the lending area, and the board of directors is not properly discharging its duties and responsibilities. If no exception is taken to the objectives, policies, and practices, the international loan portfolio can then be reviewed to ensure compliance.

The failure of the directors to establish a sound international lending policy, of the management to establish adequate written procedures, or of both to monitor and administer the international lending function within established guidelines has resulted in serious problems for banks. Major sources and causes of loan trouble, as discussed in domestic "Loan Portfolio Management," section 2040, also apply to international lending.

International—Loan Portfolio Management
Examination Objectives
Effective date May 1996

Section 7020.2

1. To determine if policies, practices, procedures, and internal controls for international loan portfolio management are adequate.
2. To determine if bank officers are operating in conformance with the established bank guidelines.
3. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
4. To determine the overall quality of the international loan portfolio and how that quality affects the soundness of the bank.
5. To prepare information on the bank's lending function in a concise, reportable format.
6. To determine compliance with applicable laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

1. If selected for implementation, complete or update the International Loan Portfolio Management section of the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjuction with performing the remaining examining procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
3. Request reports on the following from the bank's international division, by department, as of the examination date unless otherwise specified:
   a. Past-due loans. This report should cover:
      - Single payment and demand notes past due.
      - Single payment and demand notes on which interest is due and unpaid for 30 days or more.
      - Consumer, mortgage and term loans payable in regular installments on which one installment is due and unpaid for 30 days or more.
      - Outstandings under cancelled advance (overdraft) facilities that are unpaid.
      - Discounted (purchased) outgoing foreign bills matured and unpaid and advances secured by pledged delinquent foreign bills.
      - Unauthorized overdrafts including any resulting from customers not paying the bank for banker's acceptances or drafts it paid.

      And should include the following information:
      - Name of the obligor.
      - Original amount of the loan.
      - Outstanding balance of the loan.
      - Date the loan was made.
      - Due date.
      - Terms of the loan.
      - Number of payments the loan is delinquent.
      - Date of the borrower's last payment.
      - Date to which interest is paid.

      For larger international loans, the report should also include:
      - Purpose of the loan.
      - Any action being taken to bring the loan current.
   b. International loans on which interest is not being collected in accordance with the terms of the loan.
   c. International loans the terms of which have been modified by a reduction of interest rate or principal payment or by a deferral of interest or principal.
   d. International loans for which repayment terms have been restructured.
   e. International loan participations purchased and sold and participations in consortium credits since the previous examination.
   f. International loans sold in full since the previous examination.
   g. International credits considered ''problem credits'' by management (this report may be either as of the examination date or as of the date the report was last submitted to the officer's loan review committee(s), the loan and discount committee(s), or the board of directors).
   h. International credit commitments and other contingent liabilities.
   i. Loans secured by stock of other banks and rights, interest, or powers of a savings and loan association.
   j. Extensions of credit to employees, officers, directors, or their interests.
   k. Extensions of credit to executive officers, directors, principal shareholders and their interests of correspondent banks.
   l. Miscellaneous loan debit and credit suspense accounts.
   m. Current interest rate structure.
   n. Current lending authorities of officers and credit committee(s).
4. Obtain the following information:
   a. A copy of written policies covering all international lending functions.
   b. A statement of whether a standing committee administers the lending function.
   c. Copies of reports furnished to the board of directors for its meetings.
   d. Lists of directors, executive officers, principal shareholders and their interests.
   e. A summary of the officer borrowing report (debts to own and other banks).

   f. A list of previously charged-off loans approved by the directors.
5. Obtain a copy of the latest reports furnished to the international loan and discount committee(s). (The domestic loan and discount committee(s) sometimes handle(s) international loans and discounts.)
6. Review international lending policies and updates and abstract appropriate excerpts on:
   a. Distribution of loans by category.
   b. Geographic area and country exposure limitations.
   c. Type of borrowing and industrial concentration limitations.
   d. Lending authorities of committees and officers.
   e. Any prohibited types of international loans.
   f. Maximum maturities for various types of international loans.
   g. Interest rate structure.
   h. Minimum downpayment for various types of loans.
   i. Collateral appraisal policies including:
      - Persons authorized to perform appraisals.
      - Lending values of various types of assets.
   j. Financial information requirements by types of loans.
   k. Guidelines for purchasing other banker's acceptances and commercial paper.
   l. Guidelines for loans to major shareholders, directors, officers, or their interests.
7. When more than one international lending policy exists, determine if they are internally consistent by reviewing the guidelines previously obtained.
8. Review minutes of the bank's international loan and discount committee(s) meetings to obtain:
   a. Present members and their attendance record.
   b. Scope of work performed.
   c. Any information considered useful in the examination of specific loan categories or other areas of the bank.
9. Compare reports furnished to the board of directors and the loan and discount committee(s), and those received from the bank in step 3 to determine any material differences and that the differences are transmitted to the board in a timely manner.
10. Compare the lists of directors, officers and their related interests to determine:
    a. Preliminary compliance with Regulation O (12 CFR 215) (loans to insiders).
    b. Preliminary compliance with established policies.
11. Perform the following steps for past-due loans:
    a. Compare the following to determine any material inconsistencies:
       - The past-due schedule received in step 3. Delinquency reports submitted to the board.
       - List of loans considered ''problem'' loans by management.
    b. Scan the delinquency lists submitted to the board of directors and senior management to determine that reports are sufficiently detailed to evaluate risk factors.
    c. Compile current aggregate totals of past-due paper.
12. Perform the following using the loan commitments and contingent schedules obtained in step 3:
    a. Reconcile appropriate contingency totals to memoranda ledger controls.
    b. Review reconciling items for reasonableness.
13. Obtain the listing of Uniform Review of Shared National Credits and update the listing based on information obtained in step 3.
14. Obtain the classifications and categories of strong, moderately strong, and weak countries from Interagency Country Exposure Review Committee meeting for which writeups have been made available and update that data based on information obtained in step 3.
15. Distribute the applicable schedules and other information obtained in the preceding steps to the examiners performing the loan examination programs. Request that the examiners test the accuracy of the information. Also, request that they perform appropriate steps in the separate program ''Concentration of Credits.''
16. Determine the general distribution and characteristics of the international loan portfolio by:
    a. Determining the percentage of total loans in specific classes and geographic areas.
    b. Comparing international loan category distributions to policy guidelines.

17. Obtain the results of the reviews performed of the various segments of the international division during the course of the examination, and perform the following:
    a. Determine any nonadherence to internally established policies, practices, procedures, and controls.
    b. Compare the various international division results to determine the extent of nonadherence and if it is systemwide.
    c. Organize internal guideline exceptions in order of relative importance.
    d. Determine the aggregate amount of statutory bad debts.
    e. Organize violations by law and regulation.
    f. Review international credit classifications and assets listed for special mention to determine:
        - Inclusion of all necessary information.
        - Substantiation of classification or criticism.
    g. Determine the aggregate amount of credit extensions listed in each of the four levels of criticism.
    h. Compile a listing of all credit extensions not supported by current and satisfactory credit information.
    i. Compile a listing of all credit extensions not supported by complete collateral documentation.
    j. Review the separate procedures for ''Concentration of Credits'' and determine:
        - If all necessary data is included.
        - If there is substantiation for including specific items in the report of examination as a concentration.
        - If the concentration is undue or unwarranted.
    k. Compute the following ratios and compare to computations from prior examinations:
        - Aggregate international division past due paper to international division loans and overdrafts outstanding.
        - Aggregate international division "A" paper to international division past due.
        - Total international division past due, nonaccural and renegotiated rate credits to total international division credits.
        - Aggregate classified international credits to primary capital funds.
        - Aggregate classified international credit to total bank classified credits.
        - Weighted classified international credits to primary capital funds.
18. Forward the totals of international division loss and doubtful classifications to the examiner assigned to analyze the adequacy of the bank's capital.
19. Compare management's list of ''problem'' credits from step 3 to the examiner's listing of international classified and criticized credits to determine the extent of management's knowledge of its own international credit problems.
20. Determine, through an in-depth analysis of information previously generated, the causes of existing problems or weaknesses within the international division's systems which present potential for future problems.
21. Forward the following information to the examiner assigned to analyze the bank's loan loss reserves.
    a. A listing of international division credits considered "problem" credits by management.
    b. A listing of classified and criticized credits relating to the international division.
    c. A listing of previously charged-off loans.
22. Organize the results of the examination of the international lending function to facilitate discussion with the examiner-in-charge and, upon approval, with senior management of the bank.
23. During discussion with senior management, structure inquiries in such a manner as to:
    a. Gain insight into management's international lending philosophy.
    b. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks which may include:
    a. The scope of the examination of the international lending function.
    b. The quality of internal policies, practices, procedures, and controls over the international lending function.
    c. The general level of adherence to internal policies, practices, procedures, and controls that govern the bank's international lending function.
    d. The scope and adequacy of the internal loan review system regarding international credit extensions.
    e. The quality of the entire international credit portfolio.

f. The competency of management with respect to the international lending function.

g. Causes of existing credit problems.

h. Expectations for continued sound international lending and correction of existing credit control and quality deficiencies.

i. Promises made by management for correction of credit control and quality deficiencies.

j. Credit extensions to insiders and their interests.

25. Compile or prepare all information which provides substantiation for your general remarks.

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

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

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan portfolio management objectives and policies that:
   a. Establish suggested guidelines for distribution of international loans by different categories?
   b. Establish geographic area limits for credits?
   c. Establish suggested guidelines for aggregate outstanding international loans in relation to other balance sheet categories?
   d. Establish international loan authority of committees and individual lending officers?
   e. Define acceptable types of international loans?
   f. Establish maximum maturities for various types of international loans?
   g. Establish international loan pricing?
   h. Establish appraisal policy?
   i. Establish minimum financial information required at inception of the credits?
   j. Establish limits and guidelines for purchasing paper?
   k. Establish guidelines for loans to bank directors, officers, and their related interests?
   l. Establish collection procedures?
   m. Define the duties and responsibilities of international loan officers and loan committees?
   n. Outline international loan portfolio management objectives that acknowledge:
      - Concentrations of credit within specific industries and relating to country credits?
      - The need to employ personnel with specialized knowledge and experience?
      - Possible conflicts of interest?
2. Are international loan portfolio management objectives and policies reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are the following reported to the board of directors or its designated committees (indicate which) at their regular meetings (at least monthly):
   a. Past-due single payment loans (if so, indicate the minimum days past due for them to be included ___________)?
   b. Loans on which interest only is past due (if so, indicate the minimum days past due for them to be included ________)?
   c. Term loans on which one installment is past due (if so, indicate the minimum days past due for them to be included ___________)?
   d. Outstandings under overdraft facilities that are unpaid (if so, indicate the minimum days past due for them to be included ___________)?
   e. Discounted (purchased) outgoing foreign bills matured and unpaid (or advances collateralized by pledged delinquent foreign bills) (if so, indicate the minimum days past due for them to be included ___________)?
   f. Overdrafts resulting from a customer not paying the bank for banker's acceptances or drafts the bank paid (if so, indicate minimum days past due for them to be included ___________)?
   g. Total outstanding international loan commitments?
   h. Loans requiring special attention?
   i. New loans and loan renewals or restructured loans?
4. Are reports submitted to the board or its committees rechecked by a designated person for possible omissions prior to their submission?
5. Are written applications required for all international loans?
6. Does the bank maintain credit files for all international borrowers?
7. Does the credit file contain information on:
   a. The purpose of the loan?
   b. The planned repayment schedule?
   c. The disposition of loan proceeds?

  d. The points to be raised regarding the borrower from which to base questions during officer calling programs?
  e. Lending officer calls on customers and foreign countries?
8. Does the bank require periodic submission of financial statements by all international division borrowers whose loans are not fully secured by readily marketable collateral?
9. Is a tickler file maintained to assure that current financial information is requested and received?
10. Does the bank require submission of certified financial statements based on dollar amount of commitment (if so, state the dollar or equivalent minimum $________)?
11. Are financial statements of foreign borrowers spread in the credit file by local currency and U.S. dollar equivalents, if appropriate, on a yearly comparative basis?
12. Are borrower financial statements spread with those of comparable borrowers in the same country?
13. Does the bank perform a credit investigation on proposed and existing borrowers for new loan applications?
14. Does the bank have a periodic lending officer call program for:
  a. Customers?
  b. Countries?
15. Is it required that all international loan commitments be in writing?
16. Are international lines of credit reviewed and updated at least annually?
17. Are borrower's outstanding liabilities checked to appropriate lines of credit prior to granting additional advances?
18. Is there an internal review system (it may be a function of the internal audit department) which covers each department and:
  a. Rechecks interest, discounts, fees, commissions, and maturity date computations?
  b. Re-examines debt instruments for proper execution, receipt of all required supporting papers, and proper disclosure forms?
  c. Determines that international loan approvals are within the limits of the bank's lending authorities?
  d. Determines that international loans outstanding and committed are within the bank's foreign country or foreign currency limits?
  e. Determines that notes and debt instruments are being approved initially by the loan officer?
  f. Ascertains that new international loans are within the limitations set for the borrower by corporate resolution?
  g. Rechecks liability ledgers to determine that new loans have been accurately posted?
  h. Rechecks the preparation of maturity and interest notices?
  i. Examines entries to various general ledger loan controls?
  j. Confirms collateral, loans, and discounts with customers on a test basis?
19. Does the bank have an international loan review section or the equivalent?
20. Is the loan review section independent of the international lending function?
21. Are the initial results of the international loan review process submitted to a person or committee which is also independent of the international lending function?
22. Are all international loans exceeding a certain dollar amount selected for review?
23. Do international lending officers recommend loans for review?
24. Is a method, other than those detailed in steps 23 or 24, used to select international loans for review (if so, provide details)?
25. Are internal reviews conducted at least annually for all international lending areas?
26. In an officer identification system, are guidelines in effect which define the consequences of an officer withholding a loan from the review process?
27. Is the bank's international problem loan list periodically updated by the lending officers?
28. Does the bank maintain a list of international loans reviewed, indicating the date of the review and the credit rating?
29. Does the loan review section prepare summaries to substantiate credit ratings, including pass loans?
30. Are loan review summaries maintained in a central location or in appropriate credit files?
31. Are followup procedures in effect for internally classified international loans, including an update memorandum to the appropriate credit file?
32. Are officers and employees prohibited from holding blank signed notes and other debt

instruments in anticipation of future borrowings?

33. Are paid and renewed notes cancelled and promptly returned to customers?
34. Do loan proceeds disbursed in cash require a customer receipt?
35. Are international loan records retained in accordance with record retention policy and legal requirements?
36. Are new notes microfilmed daily?
37. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
38. Does the bank maintain loan interest, discount, fee, and commission rate schedules for various types of international loans?
39. Does the bank periodically update the above rate schedules (if so, state normal frequency ___________)?
40. Does the bank maintain records in sufficient detail to generate the following information by type of advance:
    a. The cost of funds loaned?
    b. The cost of servicing loans, including overhead?
    c. The cost factor of probable losses?
    d. The programmed profit margin?
41. Does the international division maintain adequate and current country analysis information?
42. Has the international division conducted studies for those industries in which it is a substantial lender?

CONCLUSION

43. 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.
44. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

A bank's international division lends, either directly or through state entities, to U.S. importers and exporters, foreign companies, multinational corporations, foreign banks, and foreign governments. The terms of these lending activities are consistent with the purpose of the financing.

Short-term working-capital loans to commercial business enterprises commonly finance inventories or receivables arising from trade. Receivable pledges, warehouse receipts, and liens on inventory or commodities may be held as collateral. However, in certain countries, these forms of collateral are not legally recognized and, therefore, the banks must be thoroughly familiar with applicable local laws, regulations, and practices. Loans to foreign banks are usually short-term and unsecured.

Medium-term lending (one to five years) generally represents capital goods financing, shipping loans, and various specialized credits. Long-term loans (those exceeding five years) are normally used to finance extensive projects of multinational corporations, foreign governments, or foreign state entities. Government guarantees of private long-term loans are common when the project has significant importance to a national economy.

The methods of loan financing in an international division are the same as those for domestic lending. Loans in the international division may be direct or discounted. In both of these instances, the bank holds a promissory note or similar instrument evidencing indebtedness. Current account advances, however, are a category of loans unique to international banking. This method of financing is an American substitute, used by banks in the United States, for the European method of financing by overdrafts, which is also a common lending method of overseas offices of U.S. banks. Current account advances, like overdrafts, are extensions of credit in which no instrument of specific indebtedness is used; however, a signed agreement is on file stating the conditions applicable to advances made by the bank to the obligor. Other types of international financing treated as loans include own acceptances purchased (discounted), other banker's acceptances purchased, and discounted trade acceptances.

The same credit risks apply to international division loans as to those made in domestic loan departments, with the addition of country risk, which is the primary additional component that distinguishes an international loan from a domestic loan. Country risk encompasses the entire spectrum of risks arising from the economic, social, and political environments of a foreign country and from the governmental policies structured to respond to those conditions that may have adverse consequences for the repayment of a foreign borrower's debt. More specifically, there is a risk associated with a borrower's capacity to obtain the foreign exchange required to service its cross-border debt (that is, transfer risk). An obligor may have the financial means in its domestic currency to repay its indebtedness, but nationalization, expropriation, governmental repudiation of external indebtedness, the imposition of exchange controls, or currency devaluation may preclude the lender from obtaining timely repayment. Apart from a nation's outright repudiation of external debt, these developments might not result in an uncollectible extension of credit; however, the delay in collection could adversely affect the condition of the lending bank.

This section is designed to apply to most types of loans and current account advances found in an international division. However, lending areas in many international divisions and overseas branches are often segregated into separate departments and differ substantially from international loans and current account advances. Those are discussed in separate sections of this manual: "International—Financing Foreign Receivables," "International—Banker's Acceptances," "International—Letters of Credit," and "International—Guarantees Issued," sections 7050, 7060, 7080, and 7090, respectively.

1. To determine the adequacy of policies, practices, procedures, and internal controls for international loans and advances.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to international lending procedures.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

1. If selected for implementation, complete or update the international lending section of the internal control questionnaire.
2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal and external auditors.
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 deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records.
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination, review the loan and collateral documentation, and prepare credit line cards.
6. Obtain the following information:
   a. past-due, nonaccrual, and reduced-rate loans and advances
   b. loans whose terms have been modified by a reduction in interest rate or principal payment or by a deferral of interest or principal
   c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination.
   d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   e. loan commitments and other contingent liabilities
   f. reports of the indebtedness of executive officers, principal shareholders, and their related interests to correspondent banks
   g. a list of correspondent banks
   h. extensions of credit to major stockholders of the bank and to bank employees, officers, and directors, and to their related interests (specify which officers are considered executive officers)
   i. miscellaneous loan-debit and credit-suspense accounts
   j. Interagency Country Exposure Review Committee (ICERC) determinations
   k. criticized Shared National Credits (applicable international division credits)
   l. loans considered "problem loans" by management
   m. specific guidelines in the lending policy
   n. current lending authorities of bank officers and credit committees
   o. the current interest-rate lending structure of the bank
   p. any useful information on international division credit extensions resulting from the review of the minutes of the loan and discount committee(s) and any other credit committee(s)
   q. reports on international division credit extensions furnished to the loan and discount committee(s) and any other credit committee(s)
   r. relevant reports furnished to the board of directors
   s. loans criticized during the previous examination
7. Review the information received and perform the following procedures.
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.*
      • Participations only:
        — Test participation certificates and records, and determine that the parties share in the risks and contractual payments on a pro rata basis.
        — Determine that the bank exercises similar controls and procedures over loans serviced for others as for loans in its own portfolio.
        — Determine that the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as for loans in its own portfolio.
      • All transfers:
        — Investigate any situations in which loans were transferred immediately

before the date of examination to determine if any were transferred to avoid possible criticism during the examination.

— Determine whether any of the loans transferred were either nonperforming at the time of transfer or classified at the previous examination.

— Determine that the consideration received for low-quality loans transferred from the bank to an affiliate is properly reflected on the bank's books and is equal to the fair market value of the transferred loans (while fair market value may be difficult to determine, it should at a minimum reflect both the rate of return being earned on such loans as well as an appropriate risk premium). Section 23A of the Federal Reserve Act generally prohibits a state member bank from purchasing a low-quality asset.

— Determine that low-quality assets transferred to the parent holding company or a nonbank affiliate are properly reflected at fair market value on the books of both the bank and its affiliate.

— If low-quality loans were transferred to or from another lending institution for which the Federal Reserve is not the primary regulator, prepare a memorandum to be submitted to the Reserve Bank supervisory personnel. The Reserve Bank will then inform the local office of the primary federal regulator of the other institution involved in the transfer. The memorandum should include the following information, as applicable:

(1) name of originating institution
(2) name of receiving institution
(3) type of transfer (i.e., participation, purchase or sale, swap)
(4) date of transfer
(5) total number of loans transferred
(6) total dollar amount of loans transferred
(7) status of the loans when transferred (e.g., nonperforming, classified, etc.)
(8) any other information that would be helpful to the other regulator

b. *Miscellaneous loan-debit and credit-suspense accounts.*
   - Discuss with management any large or old items.
   - Perform additional procedures as considered appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitment or contingent liability together with the combined amounts of the current loan balance, if any.

d. *Loans criticized during the previous examination.* Determine disposition of loans so criticized by transcribing the current balance and payment status or the date the loan was repaid and the source of repayment.
   - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
   - If repayment was a result of a participation, sale, or swap, refer to step 7a of this section for the appropriate examination procedures.

e. *Shared National Credits.*
   - Compare the schedule of international loans and current account advances included in the Uniform Review of National Credits program with the bank's reports of international loans outstanding.
   - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.

f. *ICERC credits.*
   - Identify any loans that were selected for review that are criticized for transfer-risk reasons by ICERC.
   - For each loan or advance so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these credits.

8. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
9. Prepare credit line cards for any international loan not previously selected for review that, on the basis of information derived

from the above schedules, requires an in-depth review.

10. Obtain customer liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other lending areas, and together decide who will review the borrowing relationship. Pass or retain complete credit line cards.
11. Prepare collateral line cards for all borrowers selected in the preceding steps.
12. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete the credit line cards, where appropriate. To analyze the international loans, perform the following procedures:
    a. Analyze balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends or ratios.
    b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure of the borrower.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate the adequacy of those sources.
    d. Ascertain compliance with provisions of credit agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment programs of the borrower's indebtedness.
    f. Relate collateral values to outstanding debt, and determine when the collateral was last appraised.
    g. Compare interest rates charged with the current interest-rate schedule of the bank, and determine that the terms are within established guidelines.
    h. Compare the original amounts of the customer's obligations to the bank with the lending officer's authority.
    i. Analyze secondary support afforded by guarantors and endorsers.
    j. Ascertain compliance with the bank's established international loan policy.
13. For loans selected for review, check the central liability file for borrowers indebted above the cutoff line or for borrowers displaying credit weakness or suspected of having additional liability in other lending areas.
14. Transcribe significant liability and other information on officers, principals, and affiliations of borrowers selected for review. Cross-reference line cards to borrowers, where appropriate.
15. Determine the bank's compliance with laws and regulations pertaining to international lending by performing the following steps:
    a. *Lending limits.*
        - Determine the bank's lending limit as prescribed by state law.
        - Determine advances or combinations of advances with aggregate balances above the limit, if any.
    b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.*
        - Obtain a listing of loans to affiliates.
        - Test-check the listing against the bank's customer liability records to determine its accuracy and completeness.
        - Ensure that loans to affiliates do not exceed limits of section 23A and Regulation W.
        - Ensure that loans to affiliates meet the collateral requirements of section 23A and Regulation W.
        - Determine that low-quality assets have not been purchased from an affiliate.
        - Determine that all covered transactions with affiliates are on terms and conditions that are consistent with safe and sound banking practices.
        - Determine that all transactions with affiliates comply with the market-terms requirement of section 23B and Regulation W.
    c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*
        - While examining the international lending function, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.

- Investigate any such suspected instances.

d. *Federal Election Campaign Act (2 USC 441b), Political Contributions and Loans.*
- While examining the international lending area, determine the existence of any loans in connection with any political campaigns.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.

e. *Regulation Y (12 CFR 225.7), Tie-In Provisions.* While reviewing international credit and collateral files, especially loan agreements, determine whether any extension of credit is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
- the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit.

f. *Insider lending activities.* The examination procedures for checking compliance with the relevant law and regulation covering insider lending activities and reporting requirements are as follows: (The examiner should refer to the appropriate sections of the statutes for specific definitions, lending limitations, reporting requirements, and conditions indicating preferential treatment.)
- *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests.* While reviewing information relating to insiders received from the bank or appropriate examiner (including loan participations, loans purchased and sold, and loan swaps)—
  - — test the accuracy and completeness of information about international loans by comparing it with the trial balance or loans sampled;
  - — review credit files on insider loans to determine that required information is available;
  - — determine that loans to insiders do not contain terms more favorable than those afforded other borrowers;
  - — determine that loans to insiders do not involve more than normal risk of repayment or present other unfavorable features;
  - — determine that loans to insiders do not exceed the lending limits imposed by Regulation O;
  - — if prior approval by the bank's board was required for a loan to an insider, determine that such approval was obtained;
  - — determine compliance with the various reporting requirements for insider loans;
  - — determine that the bank has made provisions to comply with the disclosure requirements for insider loans; and
  - — determine that the bank maintains records of public disclosure requests and the disposition of the requests for a period of two years after the dates of the requests.
- *Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (P.L. 95–630), as amended by the Garn–St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.*
  - — Obtain from, or request that the examiners reviewing due from banks and deposit accounts verify, a list of correspondent banks provided by bank management, and ascertain the profitability of those relationships.
  - — Determine that loans to insiders of correspondent banks are not made on preferential terms and that no conflict of interest appears to exist.

g. *12 USC 1828(v), Loans Secured by Bank Stock.*
- While examining international loans, determine the existence of any loans or discounts that are secured by the insured financial institution's own stock.
- In each such case, determine that the chief executive officer has promptly

reported such fact to the proper regulatory authority.

h. *12 USC 83 (Rev. Stat. 5201), made applicable to state member banks by section 9, paragraph 6, of the Federal Reserve Act (12 USC 324), Loans Secured by Own Stock (see also* Federal Reserve Regulatory Service *3–1505):*
   - While examining international loans, determine the existence of any loans secured by the bank's own shares or capital notes and debentures.
   - Confer with the examiner assigned investment securities to determine whether the bank owns any of its own shares or its own notes and debentures.
   - In each case in which such collateral or ownership exists, determine whether the collateral or ownership was taken to prevent a loss on a debt previously contracted (DPC) transaction.
   - In each case of ownership, determine whether the shares or subordinated notes and debentures have been held for a period of not more than six months.

i. *Regulation U (12 CFR 221).* While reviewing credit files, check the following for all loans that are secured directly or indirectly by margin stock and that were extended for the purpose of buying or carrying margin stock:
   - Except for credits specifically exempted under Regulation U, determine that the required Form FR U-1 has been executed for each credit by the customer and that it has been signed and accepted by a duly authorized officer of the bank acting in good faith.
   - Determine that the bank has not extended more than the maximum loan value of the collateral securing such credits, as set by section 221.7 of Regulation U, and that the margin requirements are being maintained.
   - Determine compliance with other specific exceptions and restrictions of the regulation as they relate to the credits reviewed.

j. *Regulation K (12 CFR 211) and Regulation Y (12 CFR 225), International Banking Operations.*
   - Review all applicable sections, especially those concerned with—
     - loans or extensions of credit to foreign banks,
     - loans to executive officers of foreign branches of state member banks,
     - a statement of policy or the availability of information to facilitate supervision of foreign operations, and
     - reporting and disclosure of international assets and accounting for fees on international loans.

k. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions, Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (See 31 CFR 1010.410.) (Loans secured by an interest in real property are exempt.)

l. *Export-Import Bank of the United States.* Review extensions of credit to determine compliance with Eximbank's lending standards, policies, guidelines, and regulations as they relate to direct lending programs, cooperative financing facilities, private export funding, exporter credit programs, medium-term export debt obligations, leasing, loan guarantees, export credit insurance, and discount programs.

m. *7 CFR 1400–1499, Commodity Credit Corporation.* Determine the compliance of international loans relating to Commodity Credit Corporation programs.

n. *22 CFR 200–299, Agency for International Development.* Review to determine the compliance of international loans related to Agency for International Development programs.

o. *Section 909, International Lending Supervision Act (12 USC 3908).* Section 909 of the International Lending Supervision Act of 1983 (the act) requires that FDIC-insured banks and Edge and agreement corporations prepare a written economic feasibility evaluation signed by a senior official of the banking institution for any proposed extension of credit by the lead U.S. banking institution or institutions, which individually or when aggregated with credits of other U.S. banking institutions exceeds $20 million per project, to finance the construction or operation of any mining operation, any metal or mineral primary processing operation, any metal fabricating facility or operation, or any metal-making (semi- and finished) operation located outside the United States or its territories or possessions. The act stipulates that the evaluation shall consider the profit potential, the competitive and economic impact of the project, and the reasonable expectation of repayment. The act also mandates that any new evaluations be reviewed by federal examiners in the context of every examination. The following checklist should be used to test compliance with the requirements of the act:

- Does the banking institution have a written economic feasibility evaluation for all credit extensions by that banking institution alone or in conjunction with other U.S. banking institutions, which individually or when aggregated with credits of other U.S. banking institutions exceed $20 million per project, to finance any of the designated projects?
- Is the evaluation signed by a senior officer of the examined or the lead U.S. banking institution?
- Does the evaluation consider the following:
  - — profit potential of the project
  - — impact of the project on world markets
  - — inherent competitive advantages and disadvantages of the project over the entire life of the project
  - — the likely effect of the project on the overall long-term economic development of the country in which it is located
  - — the reasonable expectation of repayment from revenues generated by the project, without regard to any subsidy provided by the government involved or any instrumentality of any country

Although the bank's evaluation should be done in a professional manner, examiners need not verify its accuracy. However, any negative responses to the foregoing questions would be indicative of noncompliance with the statute and should be discussed with the appropriate level of bank management. Any apparent violations should be cited in the examination report, along with a discussion of any remedial actions taken by bank management during the examination.

16. Perform the appropriate steps in "Concentrations of Credit," section 2050.3.
17. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans;
    b. violations of laws and regulations;
    c. loans not supported by current and complete financial information;
    d. loans on which collateral documentation is deficient;
    e. concentrations of credit;
    f. criticized loans;
    g. inadequately collateralized loans;
    h. extensions of credit to major shareholders, employees, officers, directors, and their related interests;
    i. loans whose ultimate collection is questionable for any other reason; and
    j. other matters regarding the condition of the department.
18. Provide details of classified international participation loans that are not covered by the Shared National Credit Program. Include the names and addresses of all participating state member banks and copies of the criticized loan comments.
19. Provide the examiner-in-charge with your findings on—
    a. the adequacy of written policies relating to international loans;
    b. the manner in which bank officers are operating in conformance with established policy;
    c. adverse trends within the international lending function;
    d. the accuracy and completeness of the schedules obtained from "International—Loan Portfolio Management," section 7020.3.
    e. internal control deficiencies or exceptions;
    f. recommended corrective action when policies, practices, or procedures are deficient;

g. the competency of management of the international lending function; and
h. other matters of significance.

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

Review the bank's internal controls, policies, practices, and procedures for granting and servicing international loans. The bank's system should be documented in a complete and concise manner and 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.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written international loan policies that:
   a. Establish procedures for reviewing international loan applications?
   b. Define qualified borrowers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are international loan policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary international loan records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary international loan records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle loans and post records?

5. Are the following properly recorded as "loans" for accounting and call report purposes:
   a. Acceptances of other banks purchased?
   b. Own acceptances purchased (discounted)?
   c. Customer's liability to the bank on drafts paid under letters of credit for which the bank has not been reimbursed?

*6. Is a loan delinquency report prepared for and reviewed by management frequently (if so, how often ___________)?

*7. Are inquiries about loan balances received and investigated by persons who do not process loans, handle settlements, or post records?

*8. Are bookkeeping adjustments checked and approved by an appropriate officer?

9. Is a daily record maintained summarizing loan transaction details, i.e., loans granted, payments received, and interest collected, to support applicable general ledger account entries?

10. Are frequent note (or record copy) and liability trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

INTEREST

*11. Is the preparation and posting of interest records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

12. Are any independent interest computations made and compared or adequately tested to initial interest records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

13. Are multicopy, pre-numbered records maintained that detail the complete description of collateral pledged?
14. Are the functions of receiving and releasing collateral to borrowers and of making entries in the collateral register performed by different employees?
15. Is negotiable collateral held under joint custody?
16. Are receipts obtained and filed for released collateral?
17. Are securities valued and margin requirements reviewed at least monthly?

18. When collateral support is the cash surrender value of insurance policies, is a periodic accounting received from the insurance company and maintained with the policy?
19. Is a record maintained of entry to the collateral vault?
20. Are stock powers filed separately to bar negotiability and to deter abstraction of both the security and the negotiating instrument?
21. Are securities out for transfer, exchange, etc., controlled by pre-numbered temporary vault-out tickets?
22. Are pledged deposit accounts properly coded to negate unauthorized withdrawal of funds?
23. Are acknowledgements received for pledged deposits held at other banks?
24. Is an officer's approval necessary before collateral can be released or substituted?

OTHER

25. Are notes and advance slips safeguarded during bank hours and locked in the vault overnight?
26. Are all loan rebates approved by an officer and made only by official check?
27. Does the bank have an internal review system that:
    a. Re-examines collateral items and supporting documentation for negotiability and proper assignment?
    b. Test checks values assigned to collateral when the loan is made and at frequent intervals thereafter?
    c. Determines that items released on temporary vault-out tickets are authorized and have not been outstanding for an unreasonable length of time?
    d. Determines that loan payments are promptly posted?
28. Are all notes and advances recorded on a register or similar record and assigned consecutive numbers?
29. Are payment notices prepared and sent by someone not connected with loan processing?
30. Are any notes signed by a customer in blank and held in anticipation of future borrowings properly safeguarded?
31. Are lending officers frequently informed of maturing loans and credit lines?

CONCLUSION

32. 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.
33. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

When banks engage in international lending, they undertake customary credit risk as denoted by the possibility of nonpayment because of an obligor's weak financial condition or a lack of adequate collateral protection. International lending also bears risks associated with conditions within a foreign borrower's home country; these risks are commonly referred to as country risk. Conditions that may give rise to country risk include a country's underlying economic, political, and social trends and movements that may have potential consequences for foreigners' debt and equity investments in that country. In addition to the adverse effect that deteriorating economic conditions and political and social unrest may have on the rate of default by obligors in a country, country risk includes the possibility of nationalization or expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation. An assessment about the level of country risk should reflect an evaluation of the effect of prevailing (and possible future) economic, political, and social conditions on a country's ability to sustain external debt service, as well as reflect the impact of these conditions on the credit risk of individual counterparties located in the country.

Transfer risk is a facet of country risk. It is the possibility that an asset cannot be serviced in the currency of the payment because the obligor's country lacks the necessary foreign exchange or has put restraints on its availability.[1]

The traditional examination approach to commercial credit risk is treated separately in other sections of this manual. The purpose of this section is to delineate the current examination policies, objectives, and procedures for evaluating a bank's country- and transfer-risk exposures and its management system for monitoring and controlling them.

1. Exchange controls are an example of transfer risk. The Interagency Country Exposure Review Committee (ICERC) assigns ratings to foreign exposures based on its evaluation of the level of transfer risk associated with a country. See the *Guide to the Interagency Country Exposure Review Committee Process*, which was issued in November 2008, for a comprehensive discussion of the operations of the ICERC. See also section 7040.3.

COUNTRY RISK

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

Macroeconomic Factors

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

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

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

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

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

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

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

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

Social, Political, and Legal Climate

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

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

Institution-Specific Factors

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

- the institution's business strategy and its exposure-management plans for the country;
- the mix of exposures and commitments, including the types of investments and borrowers, the distribution of maturities, the types and quality of collateral, the existence of guarantees, whether exposures are held for trading or investment, and any other distinguishing characteristics of the portfolio;
- the economic outlook for any specifically targeted industries within the country;
- the degree to which political or economic developments in a country are likely to affect the institution's chosen lines of business in the country (For instance, the unemployment rate or changes in local bankruptcy laws may affect certain activities more than others.);
- for an institution involved in capital markets, its susceptibility to changes in value based on market movements (As the market value of claims against a foreign counterparty rises, the

counterparty may become less financially sound, thus increasing the risk of nonpayment. This is especially true for over-the-counter derivative instruments.);
- the degree to which political or economic developments are likely to affect the credit risk of individual counterparties in the country (For example, foreign counterparties with healthy export markets or whose business is tied closely to supplying manufacturing entities in developed countries may have significantly less exposure to the local country's economic disruptions than do other counterparties in the country.); and
- the institution's ability to effectively manage its exposures in a country through in-country or regional representation, or by some other arrangement that ensures the timely reporting of, and response to, any problems.

Risk-Management Process for Country Risk

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

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

To effectively control the risk associated with international activities, institutions must have a risk-management process that focuses on the broadly defined concept of country risk. A sound country-risk management process includes effective oversight by the board of directors, adequate risk-management policies and procedures, an accurate country-exposure reporting system, an effective country-risk analysis process, a country-risk rating system, country-exposure limits, ongoing monitoring of country conditions, periodic stress testing of foreign exposures, and adequate internal controls and an audit function.

Oversight by the Board of Directors

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

Policies and Procedures for Managing Country Risk

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

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

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

Country-Exposure Reporting System

To effectively manage country risk, the institution must have a reliable system for capturing and categorizing the volume and nature of foreign exposures. The reporting system should cover all aspects of the institution's operations. An accurate country-exposure reporting system is also necessary to support the regulatory reporting of foreign exposures on the quarterly Country Exposure Report, FFIEC 009.

The board of directors should regularly receive reports on the level of foreign exposures. If the level of foreign exposures in an institution is significant,[2] or if a country to which the institution is exposed is considered to be high risk, exposures should be reported to the board at least quarterly. More frequent reporting is appropriate when a deterioration in foreign exposures would threaten the soundness of the institution.

Country-Risk Analysis Process

Although the nature of the country-risk analysis process and the level of resources devoted to it will vary from institution to institution, depending on the size and sophistication of its international operations, a number of considerations are relevant to evaluating the process in all institutions:

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

Country-Risk Ratings

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

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

The risk-rating systems of some institutions differentiate between public-sector and private-sector exposures. In some institutions, a country's private-sector credits cannot be rated less

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

severely than its public-sector credits (that is, the institution imposes a "sovereign ceiling" on the rating for all exposures in a country). Both are acceptable practices.

An institution's country-risk ratings may differ from the ICERC-assigned transfer-risk ratings because the two ratings differ in purpose and scope. An institution's internally assigned ratings help it to decide whether to extend additional credit, as well as how it should manage existing exposures. Such ratings should, therefore, have a forward-looking and broad country-risk focus. The ICERC's more narrowly focused transfer-risk ratings are primarily a supervisory tool and should not replace a bank's own country-risk analysis process.

The ICERC only rates countries that are in default where U.S. banks' aggregate exposures meet certain thresholds. Default occurs when a country is not complying with its external debt-service obligations or is unable to service the existing loan according to its terms, as evidenced by failure to pay principal and interest fully and on time, arrearages, forced restructuring, or rollovers. The ICERC reviews countries to which the aggregate exposure of U.S. banking organizations is at least $1 billion for at least two consecutive quarters or between $200 million and $1 billion if the exposure at five or more U.S. banks exceeds 25 percent of capital (tier 1 capital + ALLL).

For purposes of determining whether a country meets the threshold for review by the ICERC, aggregate exposure is based on the exposure reported in the most recent Country Exposure Lending Survey, which is published quarterly by the Federal Financial Institutions Examination Council (FFIEC). The Country Exposure Lending Survey summarizes the aggregate, by country, exposures of U.S. banks, bank holding companies, and Edge and agreement corporations filing the FFIEC 009 regulatory reporting form (Country Exposure Report). Specifically, aggregate exposure is the sum of "Transfer Risk Claims" and "Unused Commitments" and "Guarantees and Credit Derivatives."[3]

If a country in default does not meet at least one of the exposure criteria for two consecutive quarters, the committee decides whether it should continue to be reviewed based on the number of banks with exposure and the trend of conditions in the country.

3. The "Guarantees and Credit Derivatives" component captures the notional value of credit derivatives sold. This measure is a conservative estimate of contingent liabilities where a bank has taken exposure to a referenced credit in the given country. Netting does not take place in the reporting of credit derivatives since counterparty positions may not offset.

Country-Exposure Limits

As part of their country-risk management process, internationally active institutions should adopt a system of country-exposure limits. Because the limit-setting process often involves divergent interests within the institution (such as the country managers, the institution's overall country-risk manager, and the country-risk committee), country-risk limits will usually reflect a balancing of several considerations, including—

- the overall strategy guiding the institution's international activities,
- the country's risk rating and the institution's appetite for risk,
- perceived business opportunities in the country, and
- the desire to support the international business needs of domestic customers.

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

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

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

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

Monitoring Country Conditions

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

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

Stress Testing

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

Internal Controls and Audit

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

TRANSFER RISK

Transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt. The examination of transfer risk entails (1) the identification of selected country exposures of a bank that are considered significant relative to the bank's capital and the economic performance of the country; (2) the classifications of substandard, value-impaired, and loss; (3) a determination as to the adequacy of mandated special reserves against certain international assets classified value-impaired; (4) the analysis of those non-classified credits that warrant bank management's close attention and concentrations that warrant special comment; and (5) an in-depth assessment of the adequacy of the systems the bank employs to monitor and control this facet of international lending. Four report pages have been designed to reflect an examiner's analysis of the transfer-risk element in international lending for a particular bank, as follows.

The first page, "Selected Country Exposures," merely lists, without comments, exposures that are deemed significant in relation to a bank's capital and the economic performance of the country. Exposures, depending on the country grouping, are taken from the bank's last quarterly Country Exposure Report, FFIEC 009, and compared with the bank's capital as of the same date.

The second page, "Classifications Due to Transfer Risk," reflects credits ICERC has classified because of their transfer risk. Totals in each classification should be carried forward to the "Summary of Classified Items" page, with adjustments to eliminate those credits classified because of commercial risk, in accordance with the instructions in section 7040.3.

In December 1983, the federal banking agencies adopted examination categories for identifying credits that have been adversely affected by transfer-risk problems. In addition, the International Lending Supervision Act of 1983 requires banks to establish and maintain a special reserve when the value of international assets has been impaired by a protracted inability of the borrowers in a country to make payments on external indebtedness or when no definite prospects exist for orderly restoration of debt service. Both issues are outlined in section 7040.3.

The third page, "Nonclassified Credits Warranting Attention II; Concentrations of Transfer Risk Warranting Special Comment," identifies exposures, as of the examination date, in which a combination of the amount outstanding in relation to the bank's capital funds, the composition of the portfolio, and the economic performance of the country would warrant the bank to focus special attention on its exposure.

The fourth page, "Analysis of the Country Exposure Management System," presents in narrative form an assessment of a bank's system for monitoring and controlling its transfer-risk exposures. Included are comments relative to the bank's procedures for measuring exposure, the system for establishing country lending limits, and the bank's capability to analyze countries. Examination Conclusions and Comments in the report of examination may range from criticisms of weaknesses in the country-exposure-management system to high concentrations of risk in potentially weak or problematic countries.

COUNTRY-RISK MANAGEMENT

1. If the bank is internationally active, to determine the nature and extent of the bank's direct and indirect country-risk exposure.
2. If the bank has significant direct or indirect international exposure, to evaluate and determine whether it has in place an effective country-risk management process that is commensurate with the volume and complexity of its international activities.
3. To review and determine if the bank's system of policies, procedures, and internal controls and if its rating system and stress testing for county-risk management are adequate and reliable.
4. To determine if the bank's board of directors oversees and regularly reviews its country-risk management process, approves limits on country exposure, provides for adequate capital that is commensurate with its direct and indirect country-risk exposures, and ensures that management is effectively controlling the risk.
5. To determine if management clearly communicates the bank's country-risk management policies, standards, and practices to the affected offices and staff.
6. To determine if the scope of the bank's audit function is adequate and if the function is sufficiently comprehensive to ensure the integrity of the information senior management and the board use to monitor the bank's country-risk management process. To ensure that the board of directors or its audit committee has provided for adequate audit coverage of country-risk management functions.
7. To recommend corrective action if a bank's country-risk management process and controls are deficient in relation to the level of country-risk exposure.
8. To determine if the bank is properly preparing the Country Exposure Report, FFIEC 009, which is required to be filed quarterly with the Federal Reserve Bank of New York.
9. To identify and report individual country exposures considered significant in relation to the bank's capital and the economic performance of the country.

CLASSIFICATIONS DUE TO TRANSFER RISK

1. To evaluate the portfolio to identify those credits in countries considered subject to classification by the Interagency Country Exposure Review Committee (ICERC).
2. To determine if the bank has adequately provided the required allocated transfer risk reserves for those international assets included in the country exposures classified value impaired.
3. To develop information on the composition of those exposures subject to classification.
4. To prepare report pages on all transfer risks subject to classification.
5. To determine the effect of total transfer-risk classifications on the overall quality of the international loan portfolio, as well as on the total bank.

NONCLASSIFIED CREDITS WARRANTING ATTENTION—CONCENTRATIONS OF TRANSFER RISK WARRANTING SPECIAL COMMENT

1. To identify and report any concentrations of transfer risk warranting special comment.
2. To develop information on the composition of those concentrations for the report page.

ANALYSIS OF THE COUNTRY-RISK MANAGEMENT SYSTEM

1. To determine if the bank's policies, practices, procedures, and internal controls for the management of transfer risk are adequate.
2. To determine if bank officers are operating in conformance with established guidelines.
3. To prepare narrative commentary on the bank's country-exposure management system and on any noted deficiencies, in a concise reportable format.

COUNTRY RISK

Country risk, which has an overarching effect on the realization of an institution's foreign assets, encompasses all of the uncertainties arising from the economic, social, and political conditions in a country. It includes the possibility of deteriorating economic conditions, political and social upheaval, nationalization and expropriation of assets, government repudiation of external indebtedness, exchange controls, and currency depreciation or devaluation.

Analysis of the Country-Risk Management System

Generally, all banks have systems for appraising, monitoring, and controlling their foreign-lending activities. These systems differ from bank to bank in terms of the measure of the outstanding exposure, the independence of transfer-risk assessments and control from marketing considerations, the capability to make country judgments on the basis of analytical factors and firsthand knowledge of the country, the centralization and formality of procedures, and the level of in-depth review. When performing and updating the bank's risk assessment, the central point of contact for the institution should include an analysis of the institution's direct and indirect country-risk exposures (including any significant country-risk concentrations) and the adequacy and reliability of its country-risk management. Given the variations, banks' country-risk management systems should consist of three important components.

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

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

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

A summary of the country-risk management system should be prepared. Set forth below are guidelines and procedures for examiners to use in evaluating the systems banks use to monitor and control country-risk elements in their international loan portfolios. In assessing the quality of the country-risk management system, examiners should, as a matter of course, spot-check the accuracy of the data submitted on the Country Exposure Report, FFIEC 009. The review should include the exposures for at least several countries. Material exceptions should be commented on. To prepare this summary, the examiner should perform the following procedures:

1. Obtain any written policies, procedures, or summaries of the bank's country-risk management system. Determine whether the bank's country-risk management system includes—
   a. effective oversight by the board of directors,
   b. adequate risk-management policies and procedures,
   c. an accurate country-exposure reporting system,
   d. an effective country-risk analysis process,
   e. a country-risk rating system,
   f. country-exposure limits,
   g. ongoing monitoring of country conditions,
   h. periodic stress testing of foreign exposures, and
   i. adequate internal controls and an audit function. (See SR-02-5.)

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

When reporting on the bank's country-risk management system, the examiner should consider factors such as—

1. the quality of internal policies, practices, procedures, and controls over the international-lending functions;
2. the scope and adequacy of the internal loan-review system as it pertains to country risk;
3. causes of existing problems;
4. commitments from management for correction of deficiencies;
5. expectations for continued sound international lending or correction of existing deficiencies;
6. the ability of management to monitor and control transfer risk;
7. the general level of adherence to internal policies, practices, procedures, and controls; and
8. the scope and adequacy of the bank's analysis of country conditions.

TRANSFER RISK

Transfer risk is one facet of the more broadly defined concept of country risk. Transfer risk focuses more on the availability of foreign exchange to service a country's external debt.

The transfer-risk examination procedures emphasize diversification of exposure in relation to a bank's capital as the primary method of moderating transfer risk. Where concentrations are noted, the degree of risk inherent therein is assessed in light of the composition of the portfolio and the general economic and political factors that may affect the debt-service capacity of the individual countries.

INTERAGENCY COUNTRY EXPOSURE REVIEW COMMITTEE

The Interagency Country Exposure Review Committee (ICERC) is responsible for providing an assessment of the degree of transfer risk that is inherent in the cross-border and cross-currency exposures of U.S. banks. The ICERC's transfer-risk ratings are primarily a supervisory tool and should not replace a bank's own country-risk analysis process. Supervisors expect institutions under their supervision to continue to monitor closely their cross-border exposure to all countries; to have robust country-risk assessment systems; to have appropriate sovereign exposure limits in place for each sovereign entity; to perform solid financial analysis on the sovereign entities to which the institutions are exposed; and, generally, to continue to apply sound risk management to all of their cross-border exposures, not just to the countries rated by ICERC. Such risk-management functions will continue to be evaluated during the course of regular supervisory examinations. While banks are advised of the results of the ICERC's evaluations, this information is sensitive, and adequate safeguards should be established to ensure that it is not accessible to unauthorized personnel. The chief executive officers of those banks filing the quarterly FFIEC 009 receive copies of the write-ups on classified countries for *only* those classifications applicable to their own bank. In no event should the complete listing of country groupings be divulged. This approach parallels that of the Shared National Credit Program.

To promote uniform and consistent application of these procedures, examiners should avoid ad hoc interpretations of the instructions and should address all questions to their respective offices. The federal banking agencies have developed a publication, *Guide to the Interagency Country Exposure Review Committee Process*, to clarify and make more transparent the role of the ICERC in the supervisory process. (See SR-08-12.)

Application of ICERC Ratings

ICERC transfer-risk ratings are applicable in—

- every U.S.-chartered insured commercial bank in the 50 states of the United States, the District of Columbia, Puerto Rico, and U.S. territories and possessions;
- every U.S. bank holding company, including its Edge and agreement corporations and other domestic and foreign nonbank subsidiaries; and
- the U.S. branches and agencies of foreign banks (however, the allocated transfer-risk reserve (ATRR) requirement does not apply to these entities).

ICERC ratings are generally applicable to all types of foreign assets held by an institution, with the exception of premises, other real estate owned, and goodwill. For purposes of the ICERC rating, the determination of where the transfer risk for a particular exposure lies takes into consideration the existence of any guarantees and is based on the country of residence of the ultimate obligor. (See the instructions for the FFIEC 009.)

The ICERC transfer-risk rating is the only rating applicable to sovereign exposures in a reviewed country (that is, direct or guaranteed obligations of the country's central government or government-owned entities). However, if they are carried on the institution's books as an investment, securities issued by a sovereign entity are also subject to the FFIEC's Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks. The FFIEC agreement provides for specific, and possibly more severe, classification treatment of sub-investment-quality securities. Furthermore, except as noted in the next paragraph, the ICERC transfer-risk rating is also the minimum risk rating applicable to *all other* cross-border and cross-currency exposures of U.S. banks in a reviewed country.

Regardless of the currencies involved, to the extent that an institution's claims on local country residents are funded by liabilities to local country residents, the ICERC's transfer-risk ratings *do not* apply. For example, to the extent that it has liabilities to local residents (such as sterling deposits), claims of the London branch of a U.S. bank on a public- or private-sector obligor in the United Kingdom (whether the claims are denominated in sterling, dollars, or euros) are not subject to the ICERC transfer-risk rating.

The ICERC is not able to evaluate the credit risk associated with individual, private-sector exposures in a country. Therefore, based on an evaluation of credit-risk factors (including the effects of country risk), examiners may assign credit-risk ratings to individual, private-sector exposures that are more severe than the ICERC-assigned transfer-risk rating for the country. For any given private-sector exposure, the applicable rating is *the more severe* of either the ICERC-assigned transfer-risk rating for the country or the examiner-assigned credit-risk rating (including ratings assigned as a result of the Shared National Credit Program).

Questions sometimes arise concerning the consideration that examiners should give to informal expressions of support by the central government of a country for a particular borrower or sector of the economy (most often, banking). Unless they constitute a guarantee or other legally binding commitment, examiners should view such expressions of support as no more than a mitigating factor in their evaluation of the counterparty's credit risk. Informal expressions of support by the central government would not cause the counterparty's credit-risk rating to revert to the ICERC-assigned transfer-risk rating for the country.

Special Categories of Exposure

Although the ICERC may have rated ordinary short- and/or long-term exposures in a country as substandard, value-impaired, or loss, several special categories of exposure in a country may receive a less severe transfer-risk rating if certain conditions are met, as described below.

- *Performing short-term bank and performing short-term trade exposures.*[1] Short-term bank and trade exposures, which have maturities of one year or less, are generally considered to have a lower level of transfer risk because, historically, they have received priority in the allocation of a country's foreign-exchange resources. In recognition of their historical performance, the ICERC usually assigns a more favorable rating to these types of exposures.
- *Securities held in trading accounts.* Presuming that there is an active and liquid market for the securities and that the bank has procedures in place to appropriately value them, the ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific securities held in the bank's trading account. In any case, because FASB Financial Accounting Standard No. 115 requires that they be marked-to-market, trading-account securities are not subject to an ATRR requirement.
- *Direct-equity investments.* The ICERC may, on a case-by-case basis, assign a less severe transfer-risk rating to specific direct-equity investments when *all* of the following conditions are met:
  - — The investment has been marked-to-market or is valued using the equity-accounting method.
  - — The institution has provided the ICERC with evidence that the foreign business is financially viable.
  - — The institution has provided the ICERC with evidence of its ability to repatriate dividends, interest payments, and proceeds from the sale of assets on a timely basis.

EXAMINATION REPORTING OF TRANSFER RISK

The entire examination section dealing with transfer risk should be placed in an international

1. A *performing credit* is current and has not been restructured to avoid delinquency or because of a deterioration in the financial condition of the borrower. A credit is considered "current" if it has not been reported as "past due" or "nonaccrual" for the bank call report. *Trade credit* consists of credit extensions that are directly related to imports or exports and that will be liquidated through the proceeds of international trade. These credit extensions will include pre-export financing only when there is a firm export sales order and the proceeds of the order will pay off the indebtedness.

operations section of the commercial report of examination. In addition, the discussion of transfer-risk assets should be separated from the discussion of all other loans and assets classified or specially mentioned elsewhere in the report.

Selected Country Exposures

A list should be presented of those transfer-risk exposures considered large relative to the bank's own capital funds, after taking into account the economic, social, and political circumstances within a country. These exposures, which comprise total claims and contingencies, should be taken from the last quarterly FFIEC 009 filed by the bank under examination and compared with consolidated bank capital as of the same date. For this purpose, capital is defined as tier 1 and tier 2, and it should be footnoted as such on this page. The examiner should also note that this report of country exposure and its comparison with bank capital may differ from actual exposure as of the date of examination. The level at which exposure is listed is based on a review of the performance of each country by the ICERC.

Examiners are encouraged to review the instructions for preparing the country-exposure report for further information concerning the preparation of this page. While it is not expected that examiners review the country-exposure reports filed between examinations for accuracy, a spot-check to verify that such reports are being prepared properly should be made. Material reporting errors uncovered during the examination should be included in comments on reporting exceptions elsewhere in the report of examination. When bank management relies on the data generated for the country-exposure report, and when reporting exceptions are noted, comments should be incorporated in the analysis of the country-risk management system.

Ratings and Classifications Due to Transfer Risk

A list of exposures subject to classification as a result of transfer-risk considerations should be prepared. The decision to classify a bank's exposure to a particular country is made by the ICERC based on criteria incorporated into the provisions of the International Lending Supervision Act of 1983.

The ICERC's assessment of transfer risk reflects the committee's application of the following category definitions.

Substandard

This category applies when a country is not complying with its external debt-service obligations, as evidenced by arrearages, forced restructuring, or rollovers; and if either of the two following conditions exists:

- The country is not in the process of adopting an IMF or other suitable economic adjustment program, or is not adequately adhering to such a program.
- The country and its bank creditors have not negotiated a viable rescheduling and are unlikely to do so in the near future.

Value-Impaired

A country has protracted arrearages, as indicated by more than one of the following:

- The country has not fully paid its interest for six months.
- The country has not complied with IMF programs (and there is no immediate prospect for compliance).
- The country has not met rescheduling terms for more than one year.
- The country shows no definite prospects for an orderly restoration of debt service in the near future.

Loss

A loan is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. An example would be an outright repudiation by a country of its obligations to banks, the IMF, or other lenders.

The ICERC also prepares the write-ups supporting each classification. Examiners are to provide commentary on the disaggregation of each country exposure subject to classification. Include comments relative to the bank's country lending limit and any references to any proposed increases or decreases to such limit.

The examiner's commentary is to be followed by a standardized write-up on each country for which the bank has exposures, prepared by the ICERC.

ALLOCATED TRANSFER RISK RESERVE

The responsibility for recognizing and accounting for deterioration in the value of a bank's assets, including a deterioration due to transfer-risk problems, rests with the management of a bank and its auditors. The banking agencies also have a responsibility to ensure that banks are following reasonable and prudent policies in this regard, and that necessary adjustments are being made consistently. To ensure this, the federal banking agencies, pursuant to the International Lending Supervision Act, require U.S. banks to establish an ATRR on a consolidated basis against the risks presented in certain international assets whose value has been found by the ICERC to have been significantly impaired by protracted transfer-risk problems. The ATRR should be applied to certain international assets that have been classified for transfer-risk reasons as value-impaired. The act also requires that the ATRR be established by a charge against current income, be segregated from the bank's allowance for loan and lease losses (ALLL), be deducted from gross loans and leases, and not be included as part of bank capital.

The alternative to establishing an ATRR is the direct charge to the ALLL or a reduction in the principal amount of the asset by applying interest payments or other collections on the asset. However, if this alternative accounting treatment is used, the institution may not write up the value of the assets if the ATRR requirement is later reduced or eliminated. No ATRR provisions are required if the bank has previously written down or charged off the requisite amounts. Furthermore, no ATRR will be required on contingent liabilities. Instead, contingent liabilities to value-impaired countries will be reviewed on a case-by-case basis.

The ATRR amounts mandated will be reviewed regularly by the ICERC to determine if additional reserves are required or whether downward adjustments need to be made. Initially, special reserves would not apply to net new lending when additional loans are made in the context of an IMF or other appropriate economic adjustment program, and when the lending generally enhances the debt-service capability of the country concerned. Whether an ATRR is subsequently required for these new loans would be determined by the ICERC on the basis of performance and the continued inapplicability of the established criteria.

To calculate the reserves, examiners must multiply the reserve percentage times the amount of the adjusted exposure subject to transfer risk and the ATRR. This calculation should be done on the face amount of each loan outstanding before deducting any previous write-downs. For purposes of this computation (as noted above), interest payments that have been applied to existing loan balances are tantamount to write-downs and are an acceptable alternative to the establishment of an ATRR. The number derived after the calculation should be netted against previous write-downs to arrive at the mandated ATRR. In accordance with SR-92-2, the resulting net exposure, after adjusting for the ATRR, is included in the total classified value-impaired, but is weighted like a substandard credit *only* in determining the asset quality of the bank and other measures of financial soundness. The resulting net exposure, after adjustment for the ATRR, is included in the total classified value-impaired and is looked on as a doubtful classification *only* in determining the asset quality of the bank and other measures of financial soundness. When a shortfall exists, management should be apprised and be expected to comply with the statute in establishing the required reserve. Remarks relative to any shortfall and management's actions should be made in the Examination Conclusions and Comments. Although the general rule is that all exposures rated value-impaired are subject to the ATRR requirement, over the years there have been a number of clarifications and refinements. (See 12 CFR 28, 211.43, and 347.)

Aggregate exposures rated "Substandard" are relevant to any assessment of possible concentrations of risk, and should be factored into the evaluation of the adequacy of the bank's capital and ALLL.

OTHER MATTERS

Discussion of Transfer Risk in the Examiner's Comments and Conclusions

As a general rule, classifications due to transfer risk are included in the total assets classified and discussed under a major heading, such as "Asset Quality." Transfer-risk classifications of any significance should be highlighted. When the bank has other exposures of concern that warrant not only senior management's special attention, but the attention of the bank's board of directors, comments may be generated under a separate caption entitled "Transfer Risks." The examiner should include comments relative to the classifications; the shortfall, if any, in the mandatory reserves against exposures considered value-impaired; concentrations warranting special comment; and any other noted deficiency, such as an ineffective country-risk management system.

Sharing Information with State Banking Examiners

When an examination of a state member bank is being conducted concurrently or on a joint basis with state authorities, Federal Reserve examiners may share with state banking examiners information on those countries to which the bank under examination has exposures subject to classification or comment.

Country Categories

The complete listing of countries as prepared by the ICERC is highly confidential and for internal use only. In discussions with bank management, examiners should refer only to countries that will be commented on in that bank's examination report. In this context, any reference to a "categorization" of countries should be couched in neutral terms.

Examiners are to provide the examiner-in-charge with essential information that will help facilitate future examinations. In addition, all workpapers should be maintained in an orderly manner, properly labeled, and available for inspection when and if necessary.

International—Country Risk and Transfer Risk

Internal Control Questionnaire

Effective date April 2009

1. Has the board of directors, consistent with its duties and responsibilities, adopted written objectives and policies for international loan portfolio management? Do these policies and objectives—
   a. establish country-exposure limits for credits, including sublimits for transfer risk?
   b. establish limits for distribution of credits by type and maturity?
   c. acknowledge concentrations of credit within countries, and acknowledge the need to employ personnel with appropriate specialized knowledge and experience to supervise those concentrations?
2. Are objectives and policies for international loan portfolio management reviewed at least annually to determine if they are compatible with changing market conditions?
3. Are significant changes in country conditions or levels of exposure promptly brought to the attention of the board of directors or its designated committee?
4. Are country limits revised in response to substantive changes in economic, political, and social conditions within particular countries?
5. Is a formal analysis of country risk prepared, and are country limits reviewed, updated, and approved by the board of directors at least annually?
   a. Does the analysis take into account all aspects of the broadly defined concept of country risk, as well as any unique risks associated with specific groups of counterparties the institution may have targeted in its business strategy?
   b. Is the analysis adequately documented, and are conclusions concerning the level of risk communicated in a way that provides decision makers with a reasonable basis for determining the nature and level of the institution's exposures in a country?
   c. Are the bank's conclusions concerning a country reasonable in light of information available from other sources, including external research and rating services and the Interagency Country Exposure Review Committee (ICERC)?
6. Before granting additional advances or commitments, are outstanding advances or commitments checked against appropriate country limits?
7. Are lending officers cognizant of specific country limitations?
8. Are procedures for exceeding country limits clearly defined?
9. Does the bank have a periodic foreign call program for countries?
10. Is there an internal-review system to determine that international risk assets outstanding and committed are within the bank's foreign-exposure limits?
11. Are country-risk factors (economic, political, and social) and other factors in a particular country considered in the bank's internal periodic review of its risk assets?
12. Does the bank have an adequate, current system for country-risk analysis? Does the system consist of a regular, periodic quantitative and qualitative assessment and review of risk for each country in which the bank conducts or plans to conduct business, and does this system include—
    a. a review of country conditions on a regular basis (state the frequency and indicate who performs analyses)?
    b. a continuing review of current country data obtained from internal and external sources?
    c. an analysis of economic, political, social, and other factors affecting country risk?
13. Does the bank have a formal reporting system on country risk?
14. Does the reporting system provide complete exposure data quickly and in sufficient detail to assess particular risks?
15. Does the bank's country-risk evaluation system accurately recognize exposure from country to country, on the basis of legally binding guarantees, collateral, or reallocation by the office of responsibility?
16. Given the size and sophistication of the institution's international activities, are the resources devoted to the analysis of country risk adequate?
17. Is a regular determination made about each country's transfer risk, including whether transfer risk is increased due to the bank's heavy debt servicing or other financial

restraints, and whether the country has exchange controls and hard-currency restrictions?

18. Has the bank adequately provided the required allocated transfer risk reserves for those international assets that are included in the country exposures classified value-impaired?

INTRODUCTION

Financing foreign receivables, a specialized area of commercial lending in an international banking division, includes open-account financing, sales on consignment, advances against collections, discounting trade acceptances, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured against cross-border risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, and other U.S. and foreign organizations. Factoring is discussed in section 2180 of this manual, and accounts receivable financing is discussed in section 2160 (Asset-Based Lending) of this manual.

OPEN-ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In this type of sale, the buyer and seller agree on payment at a specified date without a negotiable instrument, such as a draft or acceptance, evidencing the obligation. In most instances, the shipping documents are sent directly to the buyer rather than through a bank. The exporter may request that the buyer make payment to the bank at which the exporter maintains an account. The advantages of an open-account sale are its simplicity, lack of bank charges, and the avoidance of stamp duties that certain countries apply to drafts.

The financing of open-account sales does have certain risks. Neither the lending bank nor the exporter have control over the shipping documents, and the buyer (importer) may take possession of the goods without the consent of the bank or exporter. In addition, if the importer does not register the goods with the proper authorities, the importer may not have access to the amount of foreign exchange necessary to pay for the imports at the time of payment. Perhaps the greatest risk in open-account financing is the lack of standard trade-financing documentation on which to base legal action against the importer in the event of default. Therefore, open-account sales are most appropriate when the buyer is a subsidiary of a related company or is well known to the seller and when the importing country has no significant economic, political, or social problems and, consequently, is not encountering foreign-exchange difficulties.

SALES ON CONSIGNMENT

Under a consignment arrangement, goods are consigned to the importer (consignee) abroad, and the exporter (consignor) retains title to them until they are sold to a third party. However, unless the shipment is made to an exporter's overseas branch or subsidiary, the exporter's credit risk may be considerable. As with open-account sales, there is a lack of standard trade-financing documentation on which to base legal action if the consignee defaults. The exporter should thoroughly understand the inherent credit risks, especially when goods are consigned to an agent, representative, or import house abroad.

In countries with free ports or free trade zones, consigned goods may be placed under bonded warehouse control in the name of a foreign bank or branch of the bank. Arrangements may then be made to release the consigned merchandise at the time it is sold. Merchandise is cleared through customs after the sale has been completed. However, that type of consignment should not be made and will not usually be accepted by foreign banks until all pertinent conditions and regulations are verified and storage facilities are arranged. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Consignment shipments financed by the bank should be limited to countries that do not have burdensome foreign-exchange restrictions and that have sufficient foreign exchange available to pay for imports.

To overcome the disadvantages of financing shipments on an open-account or consignment basis, exporters frequently ship goods against documentary collections. Consequently, the exporter, in the case of a time or arrival draft, or the exporter and the importer jointly, in the case of a sight draft, finance the shipment. The exporter and the importer may have unused credit lines with their banks and be in a position to borrow the needed money without tying the financing to the trade transaction. However, often the exporter's or the importer's regular bank lines are fully drawn down, so they may seek bank financing in the form of advances against outward collections, discounting trade acceptances, banker's acceptances, factoring, or forfaiting.

ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often obtains a loan from a bank, finance company, factor, or forfaiter using accounts receivable as security. The same general type of financing vehicle is available to exporters to finance their foreign receivables.

A common method of financing foreign receivables is through the exporter pledging all outward collections to its bank. The exporter may then borrow from the bank up to a stated maximum percentage of the total amount of receivables pledged at any one time. When notes rather than drafts are used to finance foreign receivables, they are usually paid on demand, enabling the exporter to increase or decrease the loan depending on its needs and the current amount of collections outstanding. Preferably, all of the collections lodged with the exporter's bank should be pledged to the bank. When a particular collection is paid, it is remitted by a foreign collecting bank to the exporter's bank, which has already advanced the funds to the exporter. The exporter's bank then uses the proceeds of the collection to reduce the exporter's loan.

Some exporters have no need for a continuous financing arrangement but occasionally may wish to obtain financing on only one large foreign receivable. In these instances, the exporter's bank may be willing to advance funds to the exporter with only that one receivable as security. Again, the bank establishes a maximum percentage of the amount of the receivable that it is willing to advance. When payment for the receivable is obtained, the bank uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export receivables is an accepted practice in international trade and is not considered factoring.

Besides having a lien on the exporter's outward collections, the bank usually retains recourse to the exporter, whose credit strength and reputation are of prime importance. Other factors, however, are also significant. If the foreign importers are companies with strong reputations and financial strength, the bank will likely advance a larger percentage on collections directed to them. The bank will also likely advance a larger percentage of funds to importers in those countries in which importers promptly pay drafts drawn on them. In other countries where payment is generally slow, perhaps because importers are financially weak or because U.S. dollar or other foreign-currency exchange is hard to obtain, the bank will advance a lower percentage on collections. The exporter's bank may be completely unwilling to finance collections directed to importers or countries with reputations for habitually slow payments.

When a bank advances against foreign receivables, it must carefully scrutinize the supporting documents. Since the bank wishes to maintain control of the merchandise, the bill of lading should be either "to the order of" the shipper and blank-endorsed or "to the order of" the bank. The bill of lading must not be consigned to the buyer (importer) since this gives the buyer control over the goods. Also, financed shipments should be covered by adequate insurance.

DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign importer becomes a trade acceptance carrying the full credit obligation of the importer. These trade acceptances are also frequently called "trade bills" or "trade paper." The acceptance is returned to and becomes the property of the exporter, who will ask the collecting bank to present it to the importer or acceptor for payment at maturity. The exporter is, therefore, providing the financing or "carrying" its own foreign receivables. However, if the exporter needs the funds before maturity of the trade acceptance, the exporter may ask the bank to "discount" the draft. If the primary obligor (the acceptor) is a well-known company of good credit standing, the bank may be willing to discount the draft without recourse to the exporter. More commonly, however, the lending bank looks to the exporter for recourse should the primary obligor fail to pay the amount when due.

When discounting a trade acceptance, the bank applies a discount to the face amount of the draft and advances the remainder to the exporter until the draft's maturity. The bank is "buying" the trade acceptance for value and is entitled to any benefits from the primary obligor to which it is due as a holder in due course of a negotiable instrument. This is also the case whenever the bank advances against a single collection or a pool of collections. Any intermediary "collecting" bank also has a financial interest in the collection and has all the rights of a holder in due course under the Uniform Commercial Code.

BANKER'S ACCEPTANCES CREATED AGAINST FOREIGN COLLECTIONS

During periods of tight money, banks may choose to finance foreign collections by using banker's acceptances. Banker's acceptances are discussed in section 7060, "International—Banker's Acceptances," so the following comments relate only to the financing of foreign collections.

As with all acceptance financing, the exporter first submits a signed acceptance agreement to its bank. To obtain acceptance financing for foreign receivables, the exporter draws two drafts. The first is a time draft drawn on the foreign buyer (the importer) that, along with the necessary documents, is sent for collection in the usual manner. The second draft, for the same or a smaller amount as agreed to by the bank and the exporter, is drawn by the exporter on its bank and has the same tenor as the draft drawn on the importer. The bank accepts the second draft and discounts it, crediting the net amount to the exporter's account. The bank has now created a banker's acceptance that can be sold in the highly liquid acceptance market, provided the bank's reputation is solid. When payment is received from the importer, the bank applies the proceeds towards its own acceptance, which will be presented for payment if sold in the market. Should the drawee default, the bank has recourse to the drawer and can demand payment from that source.

FORFAITING

Forfaiting is basically nonrecourse financing of receivables, similar to factoring. However, although a factor normally purchases a company's short-term receivables, a forfait bank purchases notes that are long-term receivables with maximum maturities of eight years. The forfaiting bank has no recourse to the seller of the goods, but gets the notes at a substantial discount in exchange for cash. Zurich and Vienna are the centers of forfaiting. Many large banks, including U.S. institutions, provide forfaiting through either their branches or specialized subsidiaries in these cities.

Forfaiting is used when government export credits or credit guarantees are not available or when a seller does not extend long-term credits to areas such as Eastern Europe. Forfaiting is also an important method of financing for small and medium-sized companies because it enables them to engage in transactions that would normally exceed their financial capabilities. By using forfaiting, small and medium-sized concerns can immediately sell their long-term receivables without recourse.

Forfaiting presents all of the risks associated with factoring, along with the risks associated with the long-term nature of purchased receivables. The examiner should review the bank's forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to periodic political or economic turmoil and the resulting fluctuations in exchange rates.

U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS

To reduce credit, political, and other risks associated with foreign receivables financing, banks may avail themselves of a variety of guarantee and insurance plans, both public and private, that are available in many countries. Because of the complexity of the numerous plans available, an examiner must frequently rely on the technical knowledge of the staff in a bank's international division who handle these transactions. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a bank's experience with its receivables insurance and guarantee plans is indicative of its effectiveness and of whether the bank has properly met its responsibilities under the programs.

Export-Import Bank of the United States

The Export-Import Bank of the United States (Eximbank) issues to commercial banks, for a fee, guarantees of payment for foreign receivables that the bank purchases from exporters, generally without recourse to the exporter. The maturities of the receivables range from 181 days to over five years. Generally, the foreign buyer must make a cash payment, either before or upon delivery, of at least 10 percent of the invoice value, and the amount of receivables purchased by the bank without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). This guarantee covers political risks, such as inconvertibility of foreign currencies into U.S. dollars, governmental actions preventing importation of goods, war, civil strife, expropriation, and confiscation by government action. Commercial risks, basically the credit risk of the foreign purchaser, usually are covered from six months to five years.

Foreign Credit Insurance Association

The Foreign Credit Insurance Association (FCIA) is an association of leading marine, property, and casualty insurance companies. In cooperation with Eximbank, FCIA offers a comprehensive selection of credit insurance policies that protect policyholders against loss from failure to receive payment from foreign buyers.

FCIA coverage protects the exporter against the failure of the buyer to pay dollar obligations for commercial or political reasons; enables the exporter to offer foreign buyers competitive terms of payment; supports the exporter's prudent penetration of higher risk foreign markets; and gives the exporter greater liquidity and flexibility in administering a foreign receivables portfolio. The FCIA does not itself finance export sales. However, the exporter who insures account receivables against commercial and political risks is usually able to obtain financing from commercial banks and other lending institutions at lower rates and on more liberal terms than would otherwise be possible by assigning the proceeds of the FCIA insurance to the lenders.

Comprehensive FCIA policies protect exporters against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks covered include insolvency or protracted default, which may be caused by economic deterioration in the buyer's market area, shifts in demand, unanticipated competition, tariffs, or technical changes. Political risk coverage applies to defaults due to government action, such as currency inconvertibility, expropriation, and cancellation of import license, and to political disturbances, such as war, revolution, and insurrection.

FCIA generally offers four basic types of policies covering political and commercial risks:

- Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risks and 90 percent of any losses from commercial risk.
- Medium-term policies insuring transactions from six months to five years. FCIA covers up to 100 percent of political risks and 90 percent of commercial risks, with the remainder retained by the exporter.
- Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
- Master policies that include the basic insurance features of the previous policies plus discretionary and deductible provisions. Under a master policy, usually only for short-term transactions, exporters may obtain FCIA authority to grant insured credit up to a certain amount without seeking prior approval. The deductible provision, used only for commercial risks and not political risks, requires the exporter to assume a fixed amount of the first loss on total debts.

(Source: *Washington Agencies That Help to Finance Foreign Trade*, seventh edition, Bankers Trust Company, New York.)

Other Insurers

Numerous other private and governmental institutions, both in the United States and overseas, guarantee or insure risks assumed by commercial banks financing foreign receivables. Some examples of these institutions in other countries are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in Germany.

In the United States, the Overseas Private Investment Corporation (OPIC), a corporation wholly owned by the U.S. government, offers insurance against the political risks of inconvertibility, expropriation, war, revolution, and insurrection and guarantees the repayment of private U.S. loans for U.S. citizens, U.S. concerns that are substantially and beneficially U.S.-owned, and foreign concerns that are at least 95 percent owned by U.S. individuals or entities.

1. To determine if the policies, practices, procedures, and internal controls for the financing of foreign receivables are adequate.
2. To determine if bank officers are operating in conformance with established bank guidelines.
3. To evaluate the portfolio for credit quality, collectibility, and collateral sufficiency.
4. To determine the scope and adequacy of the audit function as it relates to the financing of foreign receivables.
5. To determine compliance with laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations are cited.

1. If selected for implementation, complete or update the international—financing foreign receivables section of the internal control questionnaire.
2. Determine the scope of the examination on the basis of the evaluation of internal controls and the work performed by internal or external auditors.
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 deficiencies noted in the latest reviews done by internal and external auditors from the examiner assigned to the audit review, and determine if appropriate corrections have been made.
4. Obtain trial balances of applicable customer liability records.
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare examiners' credit line cards to include—
   a. customers' aggregate foreign receivables–financing liability and
   b. debt instruments aggregating customers' total outstanding liability.
7. Obtain the following information:
   a. past-due, nonaccrual, and reduced-rate loans, advances, and acceptances
   b. loans whose terms have been modified by a reduction in the interest rate or the principal payment or by a deferral of interest or principal
   c. loans transferred, either in whole or in part, to another lending institution as a result of a sale, participation, or asset swap since the previous examination
   d. loans acquired from another lending institution as a result of a purchase, participation, or asset swap since the previous examination
   e. loan commitments and other contingent liabilities
   f. loans to principal shareholders, officers, and directors and to their related interests (indicate which officers are considered executive officers)
   g. reports on the indebtedness of executive officers and principal shareholders and their related interests to correspondent banks
   h. a list of correspondent banks
   i. miscellaneous loan-debit and credit-suspense accounts
   j. Interagency Country Exposure Review Committee determinations
   k. criticized Shared National Credits (applicable international credits)
   l. loans considered "problem loans" by management
   m. background information on directors, executive officers, principal shareholders, and their related interests
   n. specific guidelines in the lending policy governing the financing of foreign receivables
   o. current lending authorities of officers and lending committee (or committees)
   p. the current interest-rate structure
   q. any useful information obtained from the review of the minutes of the loan and discount committee or any similar committee
   r. reports furnished to the loan and discount committee or any similar committee
   s. relevant reports furnished to the board of directors
   t. loans classified during the previous examination
8. Review the information received and perform the following:
   a. *Loans transferred, either in whole or in part, to or from another lending institution as a result of a participation, sale or purchase, or asset swap.* Perform procedures in step 7a of section 7030.3, "International—Loans and Current Account Advances: Examination Procedures."
   b. *Miscellaneous loan-debit and credit-suspense accounts.*
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.

c. *Loan commitments and other contingent liabilities.* Analyze the commitments and contingent liabilities of the obligors together with the combined amounts of their current loan balances.
d. *Loans criticized during the previous examination.* Determine disposition of loans so classified by transcribing the current balance and payment status, or the date the loan was repaid and the source of repayment.
   - Investigate any situations in which all or part of the funds for the repayment came from the proceeds of another loan at the bank or as a result of a participation, sale, or swap with another lending institution.
   - If repayment was a result of a participation, sale, or swap, refer to step 7a of "International—Loans and Current Account Advances: Examination Procedures," section 7030.3, for the appropriate examination procedures.
e. *Shared National Credits.*
   - Compare the schedule of foreign receivables financed included in the uniform review of Shared National Credits Program with the listing of credits selected for review to determine which loans in the sample are portions of Shared National Credits.
   - For each loan so identified, transcribe appropriate information from the schedule to line cards. No further examination procedures are necessary in this area.
f. *Interagency Country Exposure Review Committee credits.* Identify any credits that were selected for review that are criticized for transfer-risk reasons by the Interagency Country Exposure Review Committee.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.
10. Prepare credit line cards for any loan not in the sample that, on the basis of information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to international cash accounts, over-drafts, and other loan areas, and together decide who will review the borrowing relationship. Pass or retain completed credit line cards.
12. Prepare collateral line cards for all borrowers selected in the preceding steps.
13. Obtain credit files for all borrowers for whom examiner credit line cards were prepared, and complete credit line cards, where appropriate. To analyze foreign receivables financed, perform the following procedures:
    a. Analyze the customers' balance sheets and profit-and-loss figures as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    c. Review supporting information for the major balance-sheet items and the techniques used in consolidation, determine the primary sources of repayment, and evaluate their adequacy.
    d. Determine compliance with provisions of loan agreements.
    e. Review digests of officers' memoranda, mercantile reports, credit checks, and correspondence to determine the existence of any problems that might deter the contractual repayment program.
    f. Obtain the following information:
       - *Open-account financing.*
         — whether the shipment is directed to third parties or branches and subsidiaries of the borrower
         — the financial strength and trustworthiness of the overseas buyer
         — the extent of foreign-exchange control and the availability of exchange for the importer to effect payment
         — the bank's past experience in dealing with the borrower who sells on open account
       - *Sales on consignment.*
         — whether the shipment is directed to third parties or branches and subsidiaries of the obligor
         — the financial strength and trustworthiness of the foreign consignee
         — the responsibilities of the foreign sales agent, overseas representative, or import house under contract

- the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
- whether the borrower's goods, without a definite buyer, are consigned abroad in the name of the borrower's bank or a foreign bank
- whether the goods being shipped are assigned to a responsible warehouseman
- any arrangements that have been made whereby the selling agent negotiates for the sale of the goods
- the regulations in the country of destination regarding the return of unsold consigned goods to the country of origin
- the bank's past experience in dealing with the borrower who sells on consignment

• *Advances against collections.*
- the relationship between the amount collected in a month on the collections pledged as collateral and the borrower's credit limit
- the tenor of sight drafts—a stated number of days after sight or a stated number of days after the date of the draft
- instructions regarding delivery of documents against payment (D/P) or documents against acceptance (D/A)
- whether amounts advanced against collections are within the percentage of advance limitation established
- aging of drafts (collections)
- ineligible drawees, including house bills
- concentrations of drawees
- financial strength of drawees
- unusual situations such as disputes, nonacceptance of goods, and possession of goods without payment
- dishonor and protest instructions
- any special instructions
- the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
- the bank's experience in dealing with the borrower who receives advances against collections

• *Discounted trade acceptances.*
- the relationship between the amount collected in a month on the trade acceptances discounted and the borrower's credit limit
- whether the bank discounted the trade acceptance with or without recourse
- whether the borrower retains a percentage of the trade acceptance endorsed to the bank
- aging of trade acceptances
- ineligible drawees, including house bills
- concentrations of drawees
- financial strength of the drawees
- unusual situations, such as disputes, nonacceptance of goods, and possession of goods without payment
- dishonor and protest instructions
- any special instructions
- the extent of foreign-exchange controls and the availability of exchange for that type of transaction in the country of destination
- the bank's experience in dealing with the borrower for whom its trade acceptances are discounted by the bank

• *Banker's-acceptance financing.*
- the relationship between the amount collected from the foreign buyer in a month and the borrower's credit limit
- whether the discounted draft drawn by the exporter (customer) on the exporter's bank has the same tenor as the draft addressed to the foreign buyer
- the procedures for applying payment received from the foreign buyer to pay the bank's own acceptance
- aging of time drafts drawn on the importer (drawee)
- ineligible foreign buyers (drawees), including house bills
- concentrations of foreign buyers (drawees)
- financial strength of the foreign buyers (drawees)
- disputes, nonacceptance of goods, and possession of goods without payment

— dishonor and protest instructions
— any special instructions
— the extent of foreign-exchange control and the availability of exchange for that type of transaction in the country of destination
— the bank's experience in dealing with the borrower

• *Factoring.*
— the extent the factor "guarantees" letters of credit opened by the bank in favor of overseas suppliers
— whether the title documents on import transactions are consigned to or endorsed over to the factor
— whether the importer who receives goods under trust receipt agrees to hold them in trust for the factor
— whether the imported goods held under warehouse receipt are stored in an independent warehouse for the account of the factor
— whether usance letters of credit are paid to the bank by the factor at maturity, and whether the resulting acceptances are charged to the bank customer's account for payment to the factor when due
— whether the factor borrows from the bank or creates a banker's acceptance pending payment of accounts receivable resulting from the sale of goods imported under letters of credit
— the financial strength of the importer for whom the bank opened the letter of credit
— any disputes, nonacceptance of goods, and possession of goods without payment
— the bank's experience in dealing with the factor

• *Forfaiting.*
— agings of debtor accounts purchased
— ineligible debtor accounts purchased, including affiliate receivables, if any
— concentration of debtor accounts purchased
— the adequacy of the bank's credit investigation before approving the sale (or signing of a sales contract) creating a receivable
— the financial strength of the debtor accounts purchased
— the capability of the exporter from whom receivables were purchased to provide any required after-sales service and to honor warranties
— disputes and returns
— the extent of foreign exchange restrictions, availability of exchange, and country risk involved that could jeopardize collection of receivables purchased
— the bank's experience in dealing with both the debtors and the exporter

• *U.S. and foreign receivables guarantee and insurance plans.* Determine whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.

g. Analyze secondary support offered by guarantors and endorsers.
h. Determine compliance with the bank's established international loan policy.

14. For loans in the sample, check the central liability file on borrowers indebted above the cutoff line or borrowers displaying credit weaknesses or suspected of having additional liability in other loan areas.
15. Transcribe significant liability and other information of officers, principals, and affiliations of appropriate borrowers contained in the sample. Cross-reference line cards to borrowers, where appropriate.
16. Determine compliance with laws and regulations pertaining to financing foreign receivables by performing the following steps.
    a. *Lending limits.* Determine the bank's lending limit as prescribed by state law, and note any exceptions.
    b. *Section 23A, Relations with Affiliates (12 USC 371c), and section 23B, Restrictions on Transactions with Affiliates (12 USC 371c-1), of the Federal Reserve Act, and the Board's Regulation W.* Perform procedures in step 15b of "International—Loans and Current Account Advances: Examination Procedures," section 7030.3.
    c. *18 USC 215, Receipt of Commission or Gift for Procuring Loans.*

- While examining foreign receivables financing, determine the existence of any possible cases in which a bank officer, director, employee, agent, or attorney may have received anything of value for procuring or endeavoring to procure any extension of credit.
- Investigate any such suspected irregularities.

d. *Federal Election Campaign Act (2 USC 441b), Political Contributions.*
- Determine the existence of any loans in connection with any political campaigns.
- Review each such credit to determine whether it is made in accordance with applicable banking laws and in the ordinary course of business.

e. *12 USC 1972 and Regulation Y (12 CFR 225.7), Tie-In Provisions and Exceptions.* Determine whether any credit extension is conditioned upon—
- obtaining or providing any additional credit, property, or service from or to the bank or its holding company (or a subsidiary of its holding company), other than a loan, discount, deposit, or trust service, or
- the customer not obtaining a credit, property, or service from a competitor of the bank or its holding company (or a subsidiary of its holding company), other than a reasonable condition to ensure the soundness of the credit

f. *Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders and Their Related Interests, and Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)), as amended by the Garn–St Germain Depository Institutions Act of 1982, Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks.* Perform the Regulation O procedures of ''International—Loans and Current Account Advances: Examination Procedures,'' section 7030.3.

g. *Financial Recordkeeping and Reporting of Currency and Foreign Transactions, Retention of Credit Files.* Review the operating procedures and credit file documentation, and determine if the bank retains records of each extension of credit over $10,000, specifying the name and address of the borrower, the amount of the credit, the nature and purpose of the loan, and the date thereof. (Loans secured by an interest in real property are exempt.) (See 31 CFR 1010.410.)

17. Perform the appropriate procedural steps in "Concentrations of Credit: Examination Procedures," section 2050.3.
18. Discuss with appropriate officers, and prepare summaries in appropriate report form of—
    a. delinquent loans;
    b. loans not supported by current and complete financial information;
    c. loans on which documentation is deficient;
    d. loans with credit weaknesses;
    e. inadequately collateralized loans;
    f. criticized loans, including supporting commentaries;
    g. concentrations of credit;
    h. extensions of credit to major shareholders, officers, and directors and to their related interests;
    i. violations of laws and regulations; and
    j. other matters regarding the condition of the department.
19. Evaluate the bank for—
    a. the adequacy of written policies relating to financing foreign receivables;
    b. the manner in which bank officers are operating in conformance with established policy;
    c. adverse trends in those sections of the international sector of the bank concerned with financing foreign receivables;
    d. the accuracy and completeness of the schedules obtained from ''International—Loan Portfolio Management,'' section 7020.3;
    e. recommended corrective action when policies, practices, or procedures are deficient;
    f. the competency of departmental management; and
    g. other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices, and procedures regarding foreign receivables financing. The bank's system should be documented in a complete and concise manner and 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.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written foreign receivables financing policies that:
   a. Establish procedures for reviewing financing applications?
   b. Establish standards for determining credit lines?
   c. Establish standards for determining the percentage of advances made against acceptable collections (receivables)?
   d. Define acceptable receivables (collections)?
   e. Establish minimum requirements for verification of borrower's receivables (collections)?
   f. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are foreign receivables financing policies reviewed at least annually to determine if they are compatible with changing market conditions?

ACCOUNTING RECORDS

*3. Is the preparation and posting of subsidiary records performed or adequately reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are subsidiary records reconciled, at least monthly, with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?

5. Are inquiries regarding foreign receivables financing loan balances received and investigated by persons who do not normally process documents, handle settlements, or post records?

*6. Are bookkeeping adjustments checked and approved by an appropriate officer?

*7. Is a daily record maintained summarizing transaction details, i.e., loans made, payments received, and interest collected to support applicable general ledger entries?

*8. Are frequent debt instrument and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record loan transactions?

DOCUMENTATION

9. Are terms, dates, weights, description of the merchandise, etc., shown on invoices, shipping documents, trust receipts, and bills of lading scrutinized for differences?
10. Are procedures in effect to determine if the signatures shown on the above documents are authentic?
11. Are payments received from customers scrutinized for differences in invoice dates, numbers, terms, etc.?

LOAN INTEREST

*12. Is the preparation and posting of loan interest records performed or adequately reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

13. Are independent interest computations made and compared or adequately tested to initial loan interest records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

*14. Does the bank record on a timely basis a first lien on assigned foreign receivables for each borrower?

15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the bank verify the borrower's receivables or require independent verification on a periodic basis?
17. Does the bank require the borrower to provide aged receivables schedules on a periodic basis?
18. Are underlying bills of lading covering shipments either to the order of the shipper or blank endorsed to the order of the bank rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?

ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances discounted?
21. Are all collections indexed in a collection register?
22. Do these registers furnish a complete history of the origin and final disposition of each collection against which advances were made or trade acceptances discounted?
23. Are receipts issued to loan customers for all collections received from them?
24. Are serial numbers or prenumbered forms assigned to each collection item and all related papers?

*25. Are all incoming tracers and inquiries handled by an officer or employee not connected with the processing of collections?

26. Is a daily record maintained showing the various collections which have been paid and credited to the borrower's advance?

*27. Are proceeds of paid collections credited to the correct customer's advance?

28. Is an itemized daily summary made of all interest charged and received from the exporter or importer (drawee) indicating underlying collection numbers and amounts?
29. Are payments collected from importers (drawees) by foreign banks or branches of U.S. banks forwarded directly to the bank and not through the exporter?
30. If the exporter accepts importer (drawee) payments directly, are controls established or audits of exporter's books conducted (if so, explain briefly)?
31. Are employees handling collections periodically rotated, without advance notification, to other banking duties?

*32. Is the employee handling collection proceeds required to apply them to the borrower's advance on the same business day that payment is received?

33. Is the disposition of each collection noted on the register so that verification of disposition can be made?

*34. Has a regular policy of following procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?

*35. Should the foreign drawee refuse to honor the draft, are instructions clear as to what actions should be taken by the collecting bank?

36. In the event of non-payment of the collection, is the borrower promptly notified by the bank?

*37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?

*38. Are collections above maintained under memorandum control and is the control balanced regularly?

*39. Are collections against which advances have been made or trade acceptances discounted booked by persons other than employees handling those items?

*40. Are collections carried over to the next business day adequately secured?

41. Does the customer for whom trade acceptances were discounted know whether they were purchased with or without recourse to that customer?

*42. Do all parties, i.e., the seller (exporter), importer (buyer), and banks, clearly understand whether interest, discount, and collection charges are to be absorbed by the seller or paid by the importer?

FACTORING

43. Has the bank properly surrendered the

shipping documents to the factor either through endorsement or consignment?

*44. Do bank advances or banker's acceptances to the factor in payment of sight or time draft coincide with the expected payment of the accounts receivable by the ultimate customer?

FOREIGN CREDIT INSURANCE ASSOCIATION INSURANCE

45. Is the bank aware of risks not covered under its FCIA insurance?
46. Does the bank monitor whether the borrower exceeded its FCIA established credit limits?
47. Does the bank monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the bank?
48. Is the bank aware whether the FCIA insurance is on either "simple notice" or a "special assignment" basis?
49. Does the bank retain recourse to the exporter under its FCIA arrangement?
50. Has the bank reported delinquencies to FCIA in accordance with its agreement with the Association?
51. If default occurs, does the bank file a proper claim with FCIA?

EXPORT-IMPORT BANK OF THE UNITED STATES

52. Does the bank, financing under Eximbank arrangements, have properly executed Eximbank guarantees or commitments covering transactions?
53. If the bank has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
54. If the bank has been issued an "equipment political risk guarantee" by Eximbank, does it have a written statement from the government of the country in which the equipment will be used indicating that it will permit the importation, use, and any subsequent exportation of the equipment?
55. Does the bank monitor whether loan agreements between applicable borrowers and the bank are acceptable to Eximbank?
56. Does the bank report delinquencies to Eximbank in a timely manner as specified in its agreement with that agency?
57. If default occurs, does the bank file a proper claim with Eximbank?

CONCLUSION

58. 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.
59. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

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

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

Most banker's acceptances are used to finance trade transactions. Accordingly, acceptances are often created in connection with a letter of credit, although they may arise in connection with collection or open-account transactions. (See section 7080, "International—Letters of Credit.") In general, acceptance credit is considered self-liquidating in that it must provide the means for its own payment at maturity. To accomplish this, the acceptance must be based on a specific trade transaction in which goods are being shipped before entering the channels of trade. There should be satisfactory evidence to indicate that the draft, when created, is based on an actual shipment or storage and that, at maturity of the draft, the proceeds from the sale of the goods will be used to settle the draft. To a lesser extent, acceptances also finance the domestic shipment of goods and domestic or foreign storage of readily marketable staples.

The payee of the acceptance may hold an acceptance until maturity, discount it with his or her bank, or sell it in the acceptance market. When a bank discounts (purchases) its own acceptance for the payee, its "Customer's Liability on Acceptances" (asset) and "Bank's Liability on Acceptances" (liability) accounts are reduced, and the discounted acceptance is recorded with other loans and discounts. If the accepting bank subsequently rediscounts (sells) the acceptance in the market, that acceptance is rebooked as "Customer's Liability on Acceptances" and "Bank's Liability on Acceptances," and the loan and discount accounts are reduced. Rediscounted acceptances are not considered borrowings. The customer's liability on acceptances is reduced by a customer's prepayment or anticipation of an acceptance outstanding. The bank's liability is not similarly reduced by an anticipation.

The established market for banker's acceptances in the United States is regulated by the Federal Reserve System. Federal Reserve Banks are authorized to discount or purchase eligible banker's acceptances subject to qualitative and quantitative limits, thus providing a source of liquidity to the selling banks. The creation of banker's acceptances is governed by section 13 of the Federal Reserve Act, which establishes criteria that must be met for the instrument to be eligible for either discount or purchase by a Federal Reserve Bank. The rules governing whether an acceptance meets the eligibility requirements for discount or purchase are important for two major reasons. First, acceptances meeting the conditions of eligibility are more readily salable in the market than acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, ineligible acceptances, unlike those that are eligible, are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by a Federal Reserve Bank.

Section 207 of the Bank Export Services Act (title II of P.L. 97-290), which amended section 13 of the Federal Reserve Act (12 USC 372), limits the aggregate amount of eligible banker's acceptances that may be created by a member bank to 150 percent (or 200 percent with the permission of the Board) of its paid-up and unimpaired capital stock and surplus. In addition, a member bank is prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the institution's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 percent of the aggregate of all eligible acceptances authorized for a member bank. All of the foregoing limitations are also applicable to U.S. branches and agencies of foreign banks that are subject to reserve requirements under section 7 of the International Banking Act of 1978 (12 USC 3105).

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

Examination Objectives

Effective date May 1996

1. To determine if objectives, policies, practices, procedures, and internal controls for banker's acceptances 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 as it applies to banker's acceptances.
4. To evaluate the portfolio for documentation and collateral sufficiency, credit quality, and collectibility.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when objectives, policies, practices, procedures, or internal controls are deficient or when violations of laws and regulations have been cited.

1. If selected for implementation, complete or update the banker's acceptance section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
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 deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select borrowers for examination.
6. Prepare credit line cards to include:
   a. Customer's aggregate banker's acceptance liability.
   b. Banker's acceptances aggregating the customer's total liability, listing:
      - Current balance of the acceptance.
        — Indicate any prepayments (anticipations) and portions sold under participation certificate.
      - Date the acceptance was created.
      - Tenor of the acceptance (give exact maturity date, if specified).
      - Type of acceptance.
        — Import.
        — Export.
        — Third country shipment.
        — Domestic shipment.
        — Storage.
        — To create dollar exchange.
        — Working capital and/or pre-export.
        — Refinancing of sight letters of credit.
        — Current status of the acceptance.
7. Obtain the following information, if applicable to banker's acceptances, which may necessitate inclusion of additional customers (borrowers) in the credit review:
   a. Delinquencies.
   b. Participations purchased and sold (including syndicate participations).
      - Acceptance participations sold.
      - Acceptance pool participations (borrowings).
   c. Loan commitments and other contingent liabilities.
   d. Extensions of credit to major stockholders, officers, directors and their interests.
   e. Extensions of credit to executive officers, directors and their interests of correspondent banks.
   f. Miscellaneous loan debit and credit suspense accounts.
   g. Criticized shared national credits (applicable foreign credits).
   h. Interagency Country Exposure Review Committee determinations.
   i. Extensions of credit considered "problem loans" by management.
   j. Information on directors, executive officers, principal shareholders and their interests.
   k. Specific guidelines in the lending policy pertaining to banker's acceptances.
   l. Each officer's current lending authority.
   m. The current fee structure.
   n. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   o. Reports furnished to the Loan and Discount Committee or any similar committee.
   p. Reports furnished to the directorate.
   q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Participations purchased and sold:
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.
      - Determine that the books and records of the bank properly reflect the bank's liability.
      - Investigate any participations sold immediately prior to the date of examination to determine if any were sold to

avoid possible criticism during the examination.

b. Loan commitments (including acceptance commitments) and contingent liabilities.
   - Analyze the commitment or contingent liability if the borrower has been advised of the commitment together with the combined amounts of the current loan balance, if any.

c. Banker's acceptances created for officers and directors of other banks:
   - Investigate any circumstances which indicate preferential treatment.

d. Miscellaneous loan debit and credit suspense accounts:
   - Discuss with management any large or old items relating to banker's acceptances.

e. Shared national credits:
   - Compare the schedule of banker's acceptances included in the Uniform Review of National Credits Program to the sample selection to determine which banker's acceptances in the sample are portions of shared national credits (including applicable foreign credits).
   - For each banker's acceptance so identified, transcribe appropriate information from the schedule to line sheets and return the schedule. No further examination procedures are necessary for this area.

f. Cross-border lending:
   - Review credit risk without regard to cross-border considerations which will be analyzed separately. No further examination procedures are necessary in this area.

g. Loans criticized during the previous examination:
   - Determine disposition of banker's acceptances so criticized by transcribing:
     — current balance and payment status, or
     — date the banker's acceptance was repaid and the source of repayment.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past-due status.

10. Prepare a credit line card for any banker's acceptance not in the sample which, based on information derived from the above schedules, requires an in-depth review.

11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and other loan areas and, together, decide who will review the borrowing relationship. Pass or retain completed credit line cards.

12. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the loans, perform the following procedures:

    a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine the existence of any unfavorable trends.
    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    c. Review components of the balance sheet as shown in the current financial statements and determine the reasonableness of each item as it relates to the total financial structure.
    d. Review supporting information for the major balance sheet items and the techniques used in consolidation and determine the primary sources of repayment and evaluate their adequacy.
    e. Review compliance with the provisions of acceptance agreements.
    f. Review the digest of officer's memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    g. Relate any collateral values to outstanding debt, including margin and cash collateral deposits.
    h. Compare fees charged to the fee schedule(s) and determine that the terms are within established guidelines.
    i. Compare the amount of banker's acceptances outstanding with the lending officer's authority.
    j. Analyze secondary support afforded by guarantors.
    k. Ascertain compliance with the bank's established banker's acceptance policy.

13. For banker's acceptances in the sample, check the central liability file on borrowers indebted above the cutoff and on borrowers displaying credit weaknesses or suspected of having additional liability in loan areas.
14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate obligors contained in the sample. Cross-reference line sheets to borrowers, where appropriate.
15. Determine compliance with laws, regulations, and eligibility requirements regarding banker's acceptance financing by performing the following steps:
    a. Determine bank compliance with state limits or the aggregate amount of acceptances that may be created for any one customer, and acceptances created to furnish dollar exchange.
    b. Determine compliance with stipulated aggregate liability limitations on acceptances outstanding. (See Federal Reserve Act, section 13 for single person and aggregate limitation provisions.)
    c. Determine which acceptances are ineligible and therefore subject to loan limitations imposed by state law. In general, an eligible banker's acceptance is one which must arise out of a transaction described in section 13 of the Federal Reserve Act. For details of eligibility requirements, refer to the operating provisions of the Federal Open Market Committee and interpretations of the Board of Governors of the Federal Reserve System. Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be correspondence, title documents or document transmittal letters which provide sufficient detail to judge eligibility according to established criteria. Details provided should cover:
        - Value of merchandise.
        - Description of merchandise.
        - Origin and destination of shipment.
        - Date of shipment.
        - Certification that the merchandise is not being financed elsewhere.
    d. Ensure that all of the bank's own acceptances discounted that are not rediscounted, whether eligible or ineligible, are booked as loans and thus subject to the loan limitations imposed by state law.
    e. Determine if state law imposes loan limitations on eligible acceptances of other banks purchased.
    f. Review acceptance participation agreements to determine if the purchaser has recourse to the bank in the event of default by the account party, in which case the liability would be considered a borrowing. Such borrowings may be subject to limitations on indebtedness of member banks imposed by state law.
    g. Determine acceptances issued on behalf of an affiliate which constitute extensions of credit under section 23A of the Federal Reserve Act.
16. Perform appropriate procedural steps in the Concentration of Credits section.
17. Discuss with appropriate officer and prepare summaries in appropriate report form of:
    a. Violations of laws and regulations.
    b. Acceptances not supported by current and complete financial information.
    c. Acceptances on which collateral documentation is deficient.
    d. Concentrations of credit.
    e. Criticized loans.
    f. Inadequately collateralized acceptances, if applicable.
    g. Banker's acceptances created for major shareholders, employees, officers, directors and related interests.
    h. Banker's acceptances which, for any other reason, are questionable as to quality and ultimate collection.
18. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to banker's acceptances.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the banker's acceptance department.
    d. The accuracy and completeness of the schedules obtained.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

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

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written banker's acceptance policies that:
   a. Establish procedures for reviewing banker's acceptance applications?
   b. Define qualified customers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are banker's acceptance policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

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

FEES

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

COLLATERAL

See International—Loans and Current Account Advances section.

OTHER

14. Are acceptance record copies, own acceptances discounted (purchased), and acceptances of other banks purchased safeguarded during banking hours and locked in the vault overnight?

15. Are blank (pre-signed) customer drafts properly safeguarded?
16. Are any acceptance fee rebates approved by an officer?
17. Does the bank have an internal review system that:
    a. Re-examines collateral and supporting documentation held for negotiability and proper assignment?
    b. Test checks the values assigned to collateral at frequent intervals?
    c. Determines that lending officers are periodically advised of maturing banker's acceptances or acceptance lines.
18. Does the bank's acceptance filing system provide for the identification of each acceptance, e.g., by consecutive numbering and applicable letter of credit, to provide a proper audit trail?

CONCLUSION

19. 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.
20. Based on a composite evaluation, as evidenced by answers to the foregoing questions, internal control is considered (adequate/inadequate).

U.S. banks and their overseas branches maintain interest-bearing time deposits, known as "due from banks—time," with foreign banks and overseas branches of U.S. banks. These assets may also be referred to as placements, placings, interbank placements (deposits), call money, or redeposits. Due from banks—time deposits have maturities ranging from one day to several months or years. Certain examination procedures, internal control considerations, and verification procedures in the domestic due from banks section (section 2010) are relevant to international due from banks—time. However, the specialized nature of foreign deposits necessitates additional examination procedures.

Constraints are placed on the amount member banks may deposit with domestic depository institutions. A member bank may not keep on deposit with any depository institution not having access to the Federal Reserve discount window more than 10 percent of its paid-in and unimpaired capital and surplus funds. State member banks may keep on deposit with foreign banks an amount exceeding that 10 percent limitation.

Due from banks—time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks—time deposits now consists of Eurodollars with smaller amounts in other Eurocurrencies. Other Eurocurrency time deposits are placed in substantially the same manner as Eurodollar deposits, but may be subject to differing exchange control regulations depending on the location of the office making the deposit.

Eurodollar deposits are sometimes linked with foreign-exchange transactions. As a result, the Eurocurrency deposit trader will frequently work closely with the foreign-exchange trader when making the deposit decision. Foreign-exchange brokers may act as intermediaries if warranted by market conditions, local customers, the size of the bank, or other factors.

Due from banks—time deposits are treated as deposits in the Report of Condition, but contain the same credit and country risks as loans or extensions of credit. Consequently, a prudently managed bank should place deposits only with other sound and well-managed banks. The deposit traders should be provided with a list of approved banks with which funds can be deposited up to specific limits. Due from banks—time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity, which normally receive first priority on repayment in case of insolvency. Nevertheless, as credit and transfer risk exists, exposure limits are to be established by credit officers and not by foreign-exchange or deposit traders. These limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions. Incoming confirmations of transactions from depository institutions must be carefully verified against bank records to protect against fraud and error. Similarly, a systematic follow-up on nonreceipt of incoming confirmations should be closely monitored.

Examination Objectives

Effective date May 1996

1. To determine if the policies, practices, procedures, and internal controls for due from banks—time (interbank placements and call money) are adequate.
2. To determine if bank officers and employees are operating in conformance with the established guidelines.
3. To determine that all due from banks—time accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the bank evaluates the credit quality of banks with which time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit function as it applies to international due from banks—time.
6. To determine compliance with laws and regulations.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, rulings, or regulations have been cited.

1. If selected for implementation, complete or update the Due from Banks—Time (placement and call money) section of the Internal Control Questionnaire.
2. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal and external auditors.
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 deficiencies noted in the latest review by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records pertaining to due from banks—time by currency and maturity and:
   a. Reconcile balance to department controls and general ledger.
   b. Review reconciling items for reasonableness.
5. Determine those due from banks—time deposits that are unconfirmed as of examination date and:
   - Determine why incoming matching confirmations are lacking.
   - Review the extent of follow-up procedures.
6. Using an appropriate technique, select deposit customers for examination.
7. Prepare credit line cards on the customers selected for review to include the following:
   a. Name of bank and location.
   b. Customer's aggregate due from bank-time liability.
   c. For each due from bank—time deposit placement comprising the customer's total exposure to the bank, record the following information:
      - Amount.
      - Currency.
      - Inception date.
      - Value date.
      - Maturity date.
      - Interest rate.
8. Determine whether selected customers are:
   a. Affiliates of the bank or other banks.
   b. Banks and not finance companies or commercial borrowers.
9. Obtain and review the following information, if applicable:
   a. Matured and unpaid due from banks—time deposits.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Interagency Country Exposure Review Committee determinations.
   d. Due from banks—time deposit placements that are considered problem assets by management.
   e. Specific guidelines stated in bank policy relating to due from banks—time.
   f. A current listing of due from banks—time approved customer lines.
   g. The current interest rate structure.
   h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   i. Reports furnished to the Board of Directors.
   j. Due from banks—time deposit placements that were criticized during the previous examination.
   k. A listing of due from banks—time deposits that were previously charged-off.
10. Transcribe or compare information from the above schedules to credit line cards where appropriate, and indicate any cancelled bank lines.
11. Prepare credit line cards for any due from bank—time not in the sample which, based on information derived from the above schedules, requires an in-depth review.
12. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain completed credit line cards.
13. Obtain credit files for all borrowers for whom credit line cards were prepared and complete credit line cards where appropriate. To analyze due from banks—time, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preceding financial statements, and determine

the existence of any favorable or adverse trends.

b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the customer's total financial structure.
d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
e. Compare each bank's balance sheet, profit and loss items and ratios with those of comparable banks in the same country to help identify banks which may be overextended.
f. Review compliance with provisions of due from banks—time deposit agreements.
g. Review digest of officers' memoranda, mercantile reports, credit checks and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
h. Compare interest rate(s) charged to the interest rate schedule(s), and determine that the terms are within established guidelines.
i. Compare the amount of due from banks—time deposits with:
   - Lending officer's authority.
   - Depositor's limit established by the bank.
j. Detail the major owners of the bank and whether there is any support by the government.
k. Ascertain compliance with established bank policy.

14. For banks in the sample, check the customer central liability reporting system for any other indebtedness.
15. Transcribe significant liability and other information on officers, principals and affiliates of banks contained in the sample. Cross-reference line cards to banks (borrowers), where appropriate.
16. Determine compliance with state laws and regulations pertaining to due from banks—time.
17. Determine the existence of any concentration of time deposits with other banks. Include due from banks—demand (nostro), time deposits and any call money in computation. For concentrations exceeding 25 percent of the bank's capital structure, forward information to examiners assigned "Concentrations of Credit" for possible inclusion in the report of examination.
18. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    a. Matured and unpaid due from banks—time deposits.
    b. Violations of laws and regulations.
    c. Due from banks—time deposits not supported by current and complete financial information.
    d. Due from banks—time deposits on which documentation is deficient.
    e. Concentrations.
    f. Criticized credits (portions applicable to due from banks—time deposits).
    g. Due from banks—time deposits which, for any other reason, are questionable as to quality and ultimate repayment.
    h. Other matters regarding the condition of the department.
19. Evaluate the bank with respect to:
    a. The adequacy of written policies relating to due from banks—time.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the due from banks—time department.
    d. The accuracy and completeness of the schedules.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are found to be deficient.
    g. The quality of departmental management.
    h. Other matters of significance.
20. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures regarding due from banks—time. The bank's system should be documented in a complete and concise manner and 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.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies for international due from banks—time that:
   a. Establish maximum limits of the aggregate amount of due from bank—time deposits for each:
      - The bank?
      - The currency of deposit?
      - The country of deposit?
   b. Restrict due from bank—time deposits to only those customers for whom lines have been established?
   c. Establish definite procedures for:
      - Balancing of accounts?
      - Holdover deals?
      - Rendering of reports to management, external auditors and regulating agencies?
      - Accounting cutoff deadlines?
      - Handling of interest?

CERTIFICATES OF DEPOSIT

2. Are bank issued certificates of deposits safeguarded as other negotiable investment instruments?
3. Are safekeeping receipts for certificates of deposits issued, but held by others, checked to the original purchase order for accuracy?

DEALING ROOM INSTRUCTIONS

(Although dealing room and instructions functions must be separate, often foreign exchange and due from bank—time activities relating to those functions are combined.)

4. Are dealer slips and contract/confirmation sets relating to due from banks—time numbered sequentially and checked periodically?
5. Is a positions clerk present in the dealing room to maintain dealers' memoranda records of due from bank—time deposits?
6. Is due from banks—time "instructions" (operations) organizationally and physically separate from the foreign exchange dealers?

*7. Do good communications appear to exist between the dealing room and instructions to assure:
   a. An effective working relationship with operations and management to ensure adequate control and management information?
   b. Coordination with operations regarding correct delivery/settlement instructions?

*8. Does operations maintain all official accounting records relating to due from banks—time?

*9. Does operations:
   a. Balance official records against dealing room memoranda records as scheduled by management?
   b. Check confirmations for errors?
   c. Receive, review and control dealer's slips?
   d. Handle all payments and receipts?

*10. Are confirmations compared to the general ledger entries for accuracy?

CONFIRMATIONS

*11. Does operations monitor follow-up on non-receipt of incoming confirmations?

*12. Are outgoing and incoming confirmations ever handled by dealers who initiate due from bank—time transactions?

*13. Does the bank check that there are no confirmation deals dated:
   a. Prior to the bank's own due from bank—time deal dates?
   b. After the bank's own due from bank—time deal dates?

TESTING ARRANGEMENTS

(See the Wire Transfer section.)

SIGNATURE BOOKS

*14. Are customer signature books updated with regard to those with whom regular business is transacted?

*15. Does the bank check signatures on incoming confirmations for authenticity? (Many banks do not check signatures on incoming confirmations.)

*16. Does the bank check signatures for deals with non-bank customers?

*17. Are banks that do not sign confirmations asked to confirm such practice in writing over an authorized signature?

ACCOUNT RECORDS

*18. Are subsidiary records reconciled with the general ledger accounts and reconciling items adequately investigated by persons who do not post transactions to such records?

19. Is a due from foreign bank—time deposit trial balance prepared on a periodic basis (if so, indicate frequency _______)?

20. Is a daily reconcilement made of due from bank—time deposit controls to the general ledger?

21. Are reconciliations reviewed by an officer independent of the reconciliation?

OTHER

22. Are individual interest computations checked or adequately tested by persons independent of those functions?

23. Are accrual balances for due from banks—time verified periodically by an authorized official (if so, indicate frequency _______)?

24. Do all internal entries require the approval of appropriate officials?

CONCLUSION

25. 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.

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

INTRODUCTION

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

COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

This type of letter of credit is used most commonly to finance a commercial contract for the shipment of goods from seller to buyer. A commercial documentary letter of credit is a letter addressed by a bank (issuing bank) on behalf of its customer, a buyer of merchandise (account party), to a seller (beneficiary) authorizing the seller to draw drafts up to a stipulated amount under specified terms. The beneficiary will be paid when the terms of the letter of credit are met and the required documents are submitted to the paying bank.

Generally, the issuance of letters of credit is governed by article 5 of the Uniform Commercial Code (UCC). However, if the credit is issued under New York law, the credit will be governed instead by the Uniform Customs and Practice for Documentary Credits (UCP). The parties may also stipulate that the UCP rather than the UCC applies. Letters of credit may also be governed by foreign law. Generally, letters of credit are—

- signed and in writing,
- in favor of a definite beneficiary,
- for a specific amount of money, and
- in a form clearly stating how payment to the beneficiary is to be made and under what conditions.

In addition, they are issued with a definite expiration date.

Commercial letters of credit are issued in either irrevocable or revocable form. Once the beneficiary receives an irrevocable letter of credit, it cannot be canceled or amended without the beneficiary's consent. Conversely, a revocable letter of credit can be canceled or amended by the issuing bank at any time without notice to or consent from the customer or the beneficiary.

An irrevocable letter of credit constitutes a definite commitment by the issuing bank to pay, provided the beneficiary complies with the letter's terms and conditions. In contrast, the revocable credit is not truly a bank credit but serves as a device that provides the buyer and seller with a means of settling payments. Since a revocable credit can be canceled or changed without notice, the beneficiary should not rely on the credit but rather on the willingness and ability of the buyer to meet the terms of the underlying contract.

The letter of credit may be sent to the beneficiary directly by the issuing bank or through the issuing bank's correspondent (advising bank) located in the same place as the beneficiary. The advising bank gives notice of the issuance of a letter of credit without assuming any obligation to honor demands for payment. Advised letters of credit will bear a notation by the advising bank that it makes "no engagement" or words to that effect. An irrevocable advised letter of credit is, therefore, an undertaking to pay by the issuing bank, but not by the advising bank.

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

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

(See section 7060, "International—Banker's Acceptances.")

Certain categories of commercial letters of credit, such as back-to-back and red clause credits, contain an element of risk, and banks should exercise caution in their negotiation. Similarly, deferred-payment letters of credit, which become direct assets and liabilities of a bank after presentation and receipt of the beneficiary's documents, involve greater potential risk when coupled with the length of time the credit is outstanding.

A transferable letter of credit enables the original beneficiary to transfer the rights of payment to one or more beneficiaries. Frequently, the beneficiary is a middleman who does not own the goods at the time the letter of credit is issued. Thus, the beneficiary may seek to use the letter of credit to finance the acquisition of the goods. Under the UCP, a transferable letter of credit may be transferred only once unless otherwise stated.

A revolving letter of credit allows for monthly shipments with payments being either cumulative or noncumulative. In the case of cumulative credits, undrawn amounts carry over to future periods. However, most letters of credit are nonrevolving and are valid for one transaction. Since the maximum exposure under an irrevocable revolving credit can be large, most revolving credits are issued in revocable form.

Documentation is of paramount importance in all letter of credit transactions. The bank is required to examine all documents with care to determine that they conform to all of the terms and conditions of the letter of credit. Many letters of credit are part of continuous transactions, evolving from letters of credit to sight drafts or acceptances or to notes and advances covered by trust receipts or warehouse receipts. Ultimate repayment often depends on the eventual sale of the goods involved. Thus, the proper handling and accuracy of the documents required under the letter of credit is of primary concern.

STANDBY LETTERS OF CREDIT

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

Under all letters of credit, the banker expects the customer to be financially able to meet his or her commitments. A banker's payment under a commercial credit for the customer's account is usually reimbursed immediately by the customer and does not become a loan. However, the bank makes payment on a standby letter of credit only when the customer, having defaulted on his or her primary obligation, is unable to reimburse it.

A standby letter of credit transaction involves greater potential risk for the issuing bank than a commercial documentary letter of credit. Unless the transaction is fully secured, the issuer of a standby letter of credit retains nothing of value to protect against loss, whereas a commercial documentary letter of credit provides the bank with title to the goods being shipped. To reduce the risk of a standby letter of credit, the issuing bank's credit analysis of the account party should be equivalent to the analysis of a borrower in an ordinary loan situation.

The standby letter of credit transactions of state member banks are subject to the legal restrictions of Regulation H and section 23A of the Federal Reserve Act. For reporting purposes, standby letters of credit are shown as contingent liabilities in the issuer's Report of Condition.

Under the revised capital/risk assets guidelines, banks now must allocate capital against standby letters of credit. See the capital adequacy guidelines of November 1995 for information concerning capital allocation requirements against standby letters of credit.

ANTI-BOYCOTT REGULATIONS

The Export Administration Act of 1973 prohibits banks from taking or knowingly agreeing to take actions that support any boycott against a country friendly to the United States. Under anti-boycott regulations (which are issued by the Department of Commerce and enforced by the Office of Anti-Boycott Compliance), U.S. banks are required to report letters of credit they receive that include illegal boycott terms or conditions and should establish an ongoing program to review all letters of credit. These regulations apply to both domestic and overseas branches of all U.S. banks.

The anti-boycott provisions prohibit banks from opening, negotiating, confirming, or paying international letters of credit that contain illegal terms or conditions. The improper language is most often seen in documentary letters of credit, sight reimbursements, and pass-on letters of credit, but may also appear in drafts and wire payments. Often, a bank's customer may try to add improper language orally rather than in writing. Boycott language includes clauses or requirements such as—

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

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

1. If selected for implementation, complete or update the Letters of Credit section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and 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 deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select customers for examination.
6. Prepare examiners' credit line cards for each customer selected to include:
   a. Total line available for letters of credit.
   b. Total outstanding letters of credit.
      - Undrawn amount.
      - Date of issuance.
      - Expiration date of the credit.
      - Name of the beneficiary.
      - Tenor of the drafts to be drawn.
      - Purpose for the credit.
      - Issued or confirmed.
      - Revocable or irrevocable.
      - Negotiable or non-negotiable.
      - Revolving.
        — Cumulative or noncumulative.
      - Transferable.
      - Assignable.
      - Amendments.
      - Issued on behalf of domestic banks.
      - Application (with official approval) is on file and in agreement with letter of credit terms.
      - Bank's copy is initialed by the officer who signed the original letter of credit.
7. Obtain the following information if it is applicable to the letter of credit department. Such information may necessitate inclusion of additional customers in the credit review.
   a. Delinquencies.
   b. Participations purchased and sold since the preceding examination (including syndicate participations).
   c. Loan commitments and other contingent liabilities.
   d. Letters of credit issued (or confirmed) for major shareholders, officers, directors and their related interests.
   e. Letters of credit issued (or confirmed) for employees, officers and directors of other banks.
   f. Miscellaneous loan debit and credit suspense accounts.
   g. Criticized shared national credits (applicable foreign credits).
   h. Interagency Country Exposure Review Committee determinations.
   i. Letters of credit considered problems by management.
   j. Information on directors, executive officers, principal shareholders and their interests.
   k. Specific guidelines in the lending policies.
   l. Each officer's current lending authority.
   m. Current letter of credit commission and fee structure.
   n. Any useful information obtained from the review of the minutes of the Loan and Discount Committee or any similar committee.
   o. Reports furnished to the Loan and Discount Committee or any similar committee.
   p. Reports furnished to the board of directors.
   q. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Participations purchased and sold (including syndicate participations).
      - Test participation certificates and records and determine that the parties share in the risks and contractual payments according to the agreement.

- Determine that the books and records of the bank properly show the bank's liability.
- Investigate any participations sold immediately prior to the date of examination to determine if any were sold to avoid possible criticism during the examination.

b. Loan commitments and other contingent liabilities:
- Analyze the commitment or contingent liability if the borrower has been advised of the commitment and the combined amounts of the current loan balance (if any) and the commitment or other contingent liability exceeds the cutoff.

c. Letters of credit issued (or confirmed) for officers, directors and their interests:
- Investigate any circumstances which indicate preferential treatment.

d. Letters of credit issued (or confirmed) for officers and directors of other banks.
- Investigate any circumstances which indicate preferential treatment.

e. Miscellaneous loan debit and credit suspense accounts relating to letters or credit.
- Determine liability to the bank on drafts paid under letters of credit for work which the bank has not been reimbursed by the customer.
- Investigate any large or old items.

f. Shared national credits:
- Compare the schedule of letters of credit included in the program to the bank's reports of unexpired letters of credit.
- For each letter of credit so identified, transcribe appropriate information to line cards. No further examination procedures are necessary in this area.

g. Interagency Country Exposure Review Committee credits:
- Identify any credits that were selected for review that are criticized for transfer risk reasons by the Interagency Country Exposure Review Committee.

h. Letters of credit criticized during the previous examination:
- Determine disposition of letters of credit so criticized by transcribing:
  — Current balance and payment status, or
  — Date the letter of credit was drawn down (refinanced), paid, expired or cancelled, and the source of repayment.

9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status relating to letters of credit.
10. Prepare credit line cards for any letter of credit not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, and loan areas and decide who will review the borrowing relationship. Pass or retain examination credit line cards.
12. Obtain credit files for all bank customers for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the letters of credit, perform the following procedures:
    a. Analyze balance sheet and profit and loss items as shown in current and preceding financial statements, and determine the existence of any favorable or adverse trends.
    b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.
    c. Review components of the balance sheet as shown in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.
    d. Review supporting information for the major balance sheet items and the techniques used in consolidation, and determine the primary sources of repayment and evaluate their adequacy.
    e. Review compliance with provisions of letter of credit agreements.
    f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.
    g. Relate any collateral values, including margin and cash collateral deposits, to outstanding letter of credit debt.
    h. Compare fees charged to the fee schedule(s), and determine that terms are within established guidelines.

i. Compare the amount of letters of credit outstanding with the lending officer's authority.
j. Analyze any secondary support afforded by guarantors.
k. Ascertain compliance with the bank's established commercial loan policy.
l. Analyze the following specific types of letters of credit (when applicable) to determine the following:
- For red-clause letters of credit (packing credits)—
  - — is clean advance or anticipatory drawing finance to the beneficiary (exporter or agent) authorized under the letter of credit?
  - — does the beneficiary undertake to deliver, within the expiration date, the shipping documents called for in the letter of credit?
  - — does the foreign bank make advances to the beneficiary, and is it paid by drawing its own draft on the opening bank, or is the beneficiary authorized to draw its draft on the issuing bank, and are the drafts received charged to the importer?
- For traveler's letters of credit—
  - — is a traveler's letter of credit authorizing the issuing bank's correspondent to negotiate drafts drawn by the beneficiary named in the credit, up to a specified amount, upon proper identification?
  - — is the customer furnished with a list of the issuing bank's correspondents abroad?
  - — is the letter of credit prepaid in full?
- For back-to-back letters of credit—
  - — is the backing letter of credit properly assigned as collateral to the bank issuing the letter of credit?
  - — are the terms of the letter of credit issued identical to the backing credit, except that—
    - the beneficiary and account party are different,
    - the amount may be less but not more than the backing credit,
    - the expiration date is reduced by sufficient time to allow completion of the transaction before the backing letter of credit expires, and
  - — the beneficiary of the backing letter of credit is a regular customer of the bank opening the second letter of credit?
- For standby letters of credit—
  - — do they represent undertakings to pay up to a specific amount on presentation of a draft (or drafts) or documents before a specified date?
  - — do they represent obligations to a beneficiary on the part of the issuer to—
    - repay money borrowed by or advanced to, or for the account of, a party; or
    - make payment on account of any indebtedness undertaken by the account party, or make payment on account of default by the account party in the performance of an obligation, for example, default on loans, performance of contracts, or relating to maritime liens?
- For deferred-payment letters of credit (trade-related)—
  - — does the letter of credit call for drawing of sight drafts with the provison that such drafts are not to be presented until a specified period after presentation and surrender of shipping documents to the bank?
  - — is the bank's liability for outstanding letters of credit calling for deferred payment reflected as a contingent liability until presentation of such documents?
  - — has the bank received, approved, and acknowledged receipt of the documents, thereby becoming directly liable to pay the beneficiary at a determinable future date (or dates)?
  - — will payment be made to the beneficiary in a specified number of months or quarterly, semiannually, annually, or beyond? (If the bank has advanced money to the beneficiary against the deferred-payment letter of credit, with its proceeds assigned as collateral to repay the advance, the transaction should be

treated as a loan rather than a deferred-payment letter of credit).

- For clean deferred-payment letters of credit—
  - — do such deferred-payment credits call for future payment against simple receipt without documents evidencing an underlying trade transaction?
  - — are such letters of credit shown as direct liabilities on the bank's records when drafts are presented by the beneficiary and received by the bank?
- For authority to purchase—
  - — is the authority to purchase with recourse to the drawer, without recourse to the drawer, or without recourse to the drawer but confirmed by the negotiating bank?
- For Agency for International Development (AID) letters of credit—
  - — does the bank have an AID letter of commitment authorizing the transaction?
  - — has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the AID commitment?
  - — does a letter of agreement between the bank and the foreign government exist, whereby the bank has recourse if AID fails to reimburse the bank?
- For Commodity Credit Corporation (CCC) letters of credit—
  - — does the bank have a CCC letter of commitment authorizing the bank under examination to issue letters of credit to beneficiaries supplying eligible commodities to foreign importers?
  - — in instances where the bank has issued standby letters of credit in favor of the CCC, have the following requirements been met:
    - Has at least 10 percent of the financed amount been confirmed, i.e., guaranteed by a U.S. bank, for commercial credit risk? Is the total value of the credit advised through a U.S. bank?
- For the Export-Import Bank (Eximbank) of the United States—
  - — does the bank have an agency agreement from Eximbank stating—
    - that Eximbank has entered into a line of credit with a foreign borrower,
    - the amount of the line,
    - that the bank has been designated to issue the letter of credit (or credits), and
    - that any payments made under an Eximbank-approved letter of credit will be reimbursed by Eximbank?
  - — has the bank checked to make sure that all documents, including those presented by the beneficiary, comply with the terms of both the letter of credit and the Eximbank agreement?
- For advised (notified) letters of credit—
  - — is the bank only advising the beneficiary without responsibility on its part? (These banks should not be examined unless the bank has notified the letter-of-credit terms erroneously to the beneficiary, thus resulting in a possible liability for the bank.)
- For other types of letters of credit—
  - — do any of the following U.S. government agencies and international organizations reimburse the bank for issuing letters of credit on their behalf:
    - International Bank for Reconstruction and Development (World Bank)
    - Inter-American Development Bank
    - Overseas Private Investment Corporation

13. For loans in the sample, check the central liability file on borrowers who are indebted above the cutoff, or on borrowers who display credit weaknesses or are suspected of having additional liability in other loan areas.
14. Transcribe significant liability and other information on officers, principals, and affiliations of appropriate obligors contained in the sample. Cross-reference line cards to borrowers, where appropriate.

15. Determine compliance with section 208.24 of Regulation H regarding standby letters of credit by performing the following steps:
    a. Determine which letters of credit are standby letters of credit as defined by section 208.24(a) of Regulation H.
    b. Determine that the amount of standby letters of credit does not exceed the legal limitations on loans imposed by the state (including limitations to any one customer or on aggregate extensions of credit).
        - Combine standby letters of credit with any other nonexcepted loans to the account party by the issuing bank for the purpose of applying state loan limitations to any one customer.
        - A standby letter of credit is not subject to loan limitations imposed by state law in the following instances:
            — Before or at the time of issuance of the credit, the issuing bank is paid an amount equal to the bank's maximum liability under the standby letter of credit.
            — Before or at the time of issuance, the bank has set aside sufficient funds in a segregated, clearly earmarked deposit account to cover the bank's maximum liability under the standby letter of credit.
    c. Determine, for standby letters of credit that constitute extensions of credit under section 23A of the Federal Reserve Act when issued on behalf of an affiliate, that—
        - the legal lending limits pertaining to loans to affiliates have not been exceeded, and
        - appropriate collateral requirements have been met.
    d. Determine that the bank maintains adequate control and clearly earmarked subsidiary records of its standby letters of credit in conformance with section 208.24 of Regulation H.
    e. Determine that the credit standing of the account party under any standby letter of credit is the subject of credit analysis that is equivalent to that applicable to a potential borrower in an ordinary loan situation.
16. Perform the appropriate procedural steps in the "Concentration of Credits" section.
17. Discuss with the appropriate officer (or officers) and prepare summaries in appropriate report form of—
    a. letters of credit not supported by current and complete financial information,
    b. letters of credit on which collateral documentation is deficient,
    c. inadequately collateralized letters of credit,
    d. criticized letters of credit,
    e. concentrations of credit,
    f. letters of credit issued in favor of major shareholders, employees, officers, directors, and their interests,
    g. letters of credit which, for any other reason, are questionable in quality,
    h. violations of laws and regulations, and
    i. other matters regarding the condition of the letters-of-credit department.
18. Prepare and give to the examiner-in-charge a written evaluation of the letters-of-credit department with respect to—
    a. the adequacy of written policies relating to letters of credit;
    b. the manner in which bank officers are operating in conformance with established policies;
    c. delinquencies relating to letters of credit, segregating those considered "A" paper;
    d. adverse trends within the letter-of-credit department;
    e. the accuracy and completeness of the schedules obtained;
    f. internal-control deficiencies or exceptions;
    g. recommended corrective action when policies, practices, or procedures are deficient;
    h. the quality of departmental management; and
    i. other matters of significance.
19. Update the workpapers with any information that will facilitate future examinations.

Review the bank's internal controls, policies, practices and procedures for letters of credit issued and confirmed. The bank's system should be documented in a complete and concise manner and 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.

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written letter of credit policies that:
   a. Establish procedures for reviewing letter of credit applications?
   b. Define qualified customers?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are letter of credit policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary letter of credit records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

*4. Are the subsidiary letter of credit records (control totals) balanced daily with the appropriate general ledger accounts and reconciling items adequately investigated by persons who do not normally handle letters of credit and post records?

*5. Are delinquencies arising from the nonpayment of instruments relating to letters of credit prepared for and reviewed by management on a timely basis?

*6. Are inquiries regarding letter of credit balances received and investigated by persons who do not normally process documents, handle settlements or post records?

*7. Are bookkeeping adjustments checked and approved by an apropriate officer?

*8. Is a daily record maintained summarizing letter of credit transaction details, i.e., letters of credit issued, payments received, and commissions and fees collected, to support applicable general ledger account entries?

9. Are frequent letter of credit record copies and liability ledger trial balances prepared and reconciled monthly with control accounts by employees who do not process or record letter of credit transactions?

COMMISSIONS

*10. Is the preparation and posting of commission records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

11. Are any independent commission computations made and compared or adequately tested to initial commission records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

DOCUMENTATION

12. Are terms, dates, weights, description of merchandise, etc. shown on invoices, shipping documents, delivery receipts and bills of lading scrutinized for differences with those detailed in the letters of credit instruments?
13. Are procedures in effect to determine if:
   a. The above documents are signed when required?
   b. All copies of letters of credit are initialed by the officer who signed the original letter of credit?
   c. All amendments to letters of credit are approved by an officer?

COLLATERAL

(See International—Loans and Current Account Advances section.)

DEFERRED PAYMENT LETTERS OF CREDIT

*14. Are deferred payment letters of credit:
   a. Recorded as direct liabilities of the bank after it acknowledges receipt of the beneficiary's documents?
   b. Included in "Other Assets" and "Other Liabilities" in the call report?

STANDBY LETTERS OF CREDIT

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

OTHER

16. Are outstanding letter of credit record copies and unissued forms safeguarded during banking hours and locked in the vault overnight?

*17. Are advised letters of credit recorded as memoranda accounts separate from letters of credit issued or confirmed by the bank?

18. Are letters of credit which have been issued with reliance upon a domestic bank, whether on behalf of, at the request of, or under an agency agreement with the domestic bank, recorded as contingent liabilities under the name of that domestic bank?

19. Are any commission rebates approved by an officer?

20. Does the bank have an internal review system that:
   a. Re-examines collateral items for negotiability and proper assignment?
   b. Test check values assigned to collateral when the letter of credit is issued or confirmed and at frequent intervals thereafter?
   c. Determines that customer payments of letters of credit issued are promptly posted?
   d. Determines all delinquencies arising from the non-payment of instruments relating to letters of credit?

21. Are all letters of credit recorded and assigned consecutive numbers?

22. Are lending officers frequently informed of maturing letters of credit and letter of credit lines?

CONCLUSION

23. 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.

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

State member banks may not issue guarantees and sureties except for those that may be incidental or usual in conducting banking business, such as when a bank has a substantial interest in the performance of the transaction involved or has a segregated deposit sufficient in amount to cover its total potential liability. A state member bank also may guarantee or endorse notes or other obligations sold by the bank for its own account. The amount of the obligations covered by the guaranty or endorsement is to be recorded as a liability on the bank's records. These liabilities are included in computing the aggregate indebtedness of the bank, which may be subject to limitations imposed by state law. Furthermore, a state member bank is permitted to guarantee the deposits and liabilities of its Edge Act and agreement corporations and of its corporate instrumentalities in foreign countries.

A foreign branch of a member bank may engage in certain activities under Regulation K (12 CFR 211) in addition to its general banking powers to the extent that they are consistent with its charter. Those additional activities include guaranteeing a customer's debts or agreeing to make payment on the occurrence of readily ascertainable events, including, but not limited to, nonpayment of taxes, rentals, customs duties, the cost of transportation and loss, or the nonconformance of shipping documents. The guarantee or agreement must specify maximum monetary liability. The liabilities outstanding are subject to loan limitations on any one customer imposed by state law.

A common example of a guarantee is a shipside bond. Frequently, in an international sale of goods, the merchandise arrives at the importer's (buyer's) port before the arrival of correct and complete bills of lading. In these instances, it is customary for the importer (buyer) to obtain immediate possession of the goods by providing the shipping company with a bank guarantee, often called a shipside bond, that holds the shipping company blameless for damage resulting from release of the goods without proper or complete documents. Usually, the bank's guarantee relies on a counter-guarantee issued to the bank by the importer.

All types of guarantees issued are to be recorded as contingent liabilities by the bank. Usually, the party for whom the guarantee was issued will reimburse the bank should it be required to pay under the guarantee; however, in certain situations, some other designated party may reimburse the bank. That other party may be designated in the guarantee agreement with the bank or in the guarantee instrument itself. The bank may also be reimbursed from segregated deposits held, from pledged collateral, or by a counter-guarantor. Letters of credit, as distinguished from guarantees, are discussed in section 7080, "International—Letters of Credit."

International—Guarantees Issued
Examination Objectives
Effective date May 1996

Section 7090.2

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

1. If selected for implementation, complete or update the Guarantees Issued section of the Internal Control Questionnaire.
2. Determine the scope of the examination based upon the evaluation of internal controls and the work performed by internal and external auditors.
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 deficiencies noted in the latest review done by internal and external auditors from the examiner assigned to the audit review and determine if appropriate corrections have been made.
4. Obtain a trial balance of the customer (account party) liability records and:
   a. Reconcile balances to department controls and the general ledger.
   b. Review reconciling items for reasonableness.
5. Using an appropriate technique, select guarantee account parties for examination.
6. Prepare credit line cards to include:
   a. Total line available for guarantees.
   b. Total outstanding guarantees.
7. Obtain the following information if it is applicable to the guarantees issued area:
   a. Loan commitments and contingent liabilities.
   b. Miscellaneous loan debit and credit suspense accounts.
   c. Criticized shared national credits.
   d. Interagency Country Exposure Review Committee determinations.
   e. Loans considered "problem loans" by management.
   f. Specific guidelines in the lending policy.
   g. Each officer's current lending authority.
   h. Any useful information resulting from the review of the minutes of the Loan and Discount Committee or any similar committee.
   i. Reports furnished to the Loan and Discount Committee or any similar committee.
   j. Reports furnished to the board of directors.
   k. Loans criticized during the previous examination.
8. Review the information received and perform the following for:
   a. Miscellaneous loan debit and credit suspense accounts:
      - Determine any liability to the bank resulting from guarantees paid by the bank for which it has not been reimbursed by an account party.
      - Discuss with management any large or old items.
      - Perform additional procedures as considered appropriate.
   b. Shared national credits:
      - Compare the schedule of guarantees issued included in the program to the bank's reports of unexpired guarantees.
      - For each guarantee so identified, transcribe appropriate information to line cards. No further examination procedures are necessary for these items.
   c. Interagency Country Exposure Review Committee Credits:
      - Identify any guarantees that were selected for review that are criticized for transfer risk reason by the Interagency Country Exposure Review Committee.
9. Transcribe or compare information from the above schedules to credit line cards, where appropriate, and indicate any past due status.
10. Prepare credit line cards for any guarantee not in the sample which, based on information derived from the above schedules, requires an in-depth review.
11. Obtain liability and other information on common borrowers from examiners assigned to cash items, overdrafts, loans and current account advances, due from foreign banks—time, and other loan areas and decide who will review the borrowing relationship. Pass on or retain completed credit line cards.
12. Obtain credit files for all customers (account parties) for whom credit line cards were prepared and complete credit line cards, where appropriate. To analyze the guarantees, perform the following procedures:
    a. Analyze balance sheet and profit and loss figures as shown in current and preced-

ing financial statements, and determine the existence of any favorable or adverse trends.

b. Relate items or groups of items in the current financial statements to other items or groups of items set forth in the statements, and determine the existence of any favorable or adverse ratios.

c. Review components of the balance sheet as reflected in the current financial statements, and determine the reasonableness of each item as it relates to the total financial structure.

d. Review supporting information for the major balance sheet items and the techniques used in consolidation. Determine the primary sources of repayment and evaluate the adequacy of those sources.

e. Determine compliance with the provisions of guarantee agreements.

f. Review digest of officers' memoranda, mercantile reports, credit checkings and correspondence to determine the existence of any problems which might deter the contractual liquidation program.

g. Relate collateral values, if any, to outstanding guarantee.

h. Compare fees charged to the bank's fee schedule and determine that the terms are within established guidelines.

i. Compare the original amount of the guarantee with the lending officer's authority.

j. Analyze support afforded by counterguarantors.

k. Ascertain compliance with the bank's established guarantee issued policy.

13. For guarantees issued in the sample, check central liability file on borrower(s) indebted above the cutoff or borrower(s) displaying credit weakness or suspected of having additional liability in loan areas.

14. Transcribe significant liability and other information on officers, principals and affiliations of appropriate account parties contained in the sample. Cross-reference line cards to borrowers, where appropriate.

15. Determine compliance with state laws and regulations pertaining to guarantees issued by performing the following steps:

    a. Determine that the obligations covered by such guarantees or endorsements are shown as contingent liabilities on the records and in the reports of condition of the bank and that such liabilities are included in computing the aggregate indebtedness of the bank, if such limitations are imposed by state law.

    b. Determine which guarantees are subject to individual loan limitations to any one customer by state law. Combine guarantees with any other extensions of credit to the account party by the issuing bank subject to loan limitations imposed by state law.

16. Perform appropriate procedural steps in the Concentration of Credits section, as applicable.

17. Discuss with appropriate officers and prepare summaries in appropriate report form of:

    a. Guarantees not supported by current and complete financial information.
    b. Guarantees on which collateral documentation is deficient.
    c. Concentrations of credit.
    d. Criticized guarantees.
    e. Inadequately collateraled guarantees, if applicable.
    f. Guarantees issued in favor of major shareholders, employees, officers, directors and related interests.
    g. Guarantees, which for any other reason, are questionable as to quality and ultimate collection.
    h. Violations of laws and regulations.

18. Evaluate the bank with respect to:

    a. The adequacy of written policies relating to guarantees issued.
    b. The manner in which bank officers are operating in conformance with established policy.
    c. Adverse trends within the guarantees issued department.
    d. The accuracy and completeness of the schedules obtained.
    e. Internal control deficiencies or exceptions.
    f. Recommended corrective action when policies, practices or procedures are deficient.
    g. The quality of departmental management.
    h. Other matters of significance.

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

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

POLICIES

1. Has the board of directors, consistent with its duties and responsibilities, adopted written policies pertaining to guarantees issued that:
   a. Establish procedures for reviewing guarantee applications?
   b. Define qualified guarantee account parties?
   c. Establish minimum standards for documentation in accordance with the Uniform Commercial Code?
2. Are guarantees issued policies reviewed at least annually to determine if they are compatible with changing market conditions?

RECORDS

*3. Is the preparation and posting of subsidiary guarantee records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

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

*5. Are guarantee delinquencies prepared for and reviewed by management on a timely basis?

6. Are inquiries regarding guarantee balances received and investigated by persons who do not normally handle guarantees or post records?

*7. Are bookkeeping adjustments checked and approved by an appropriate officer?

*8. Is a daily record maintained summarizing guarantee transaction details, i.e., guarantees issued, guarantees cancelled or renewed, payment made under guarantees and fees collected, which support general ledger entries?

9. Are frequent guarantee instrument and liability ledger trial balances prepared and are they reconciled monthly with control accounts by persons who do not process or record guarantee transactions?

GUARANTEE FEES

*10. Is the preparation and posting of fees collected records performed or reviewed by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

11. Are independent fee computations made, compared or adequately tested to initial fee records by persons who do not also:
   a. Issue official checks or drafts?
   b. Handle cash?

COLLATERAL

(See International—Loans and Current Account Advances section.)

OTHER

12. Are guarantees issued instruments safeguarded during banking hours and locked in the vault overnight?
13. Are all guarantees issued recorded as liabilities and assigned consecutive numbers?
14. Are all guarantees issued recorded on individual customer (account party) liability ledgers?

CONCLUSION

15. 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.

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

This section provides examiners with the basic principles and risks associated with foreign exchange trading. By its very nature, foreign exchange trading involves risk. The examiner's primary function is to understand that risk and ensure that bank management, by means of policies, limits, and systems, is controlling that risk in a prudent manner. For the purpose of this section, foreign currency money market functions will be combined with foreign exchange activities since the principles and risks are virtually the same.

In order to evaluate a bank's foreign exchange and controls, the examiner needs a basic understanding of the foreign exchange market, the commercial bank's role in the market, trading fundamentals, and the principal risks involved in trading.

The foreign exchange market exists to service the foreign currency needs of importers, exporters, manufacturers, and retailers. Foreign exchange transactions arising from international trade and investment are frequently large and recurrent.

Large or small, all foreign exchange transactions represent the exchange of one country's money for another's. The exchange rate is simply the price of one currency in terms of another.

Until the late 1970s, foreign exchange rates in this country were normally expressed and quoted in dollars per unit of foreign currency, also known as "U.S. Terms." Under this method, for example, the rate for Swiss francs would be expressed as CHFl=U.S.$1.5500. However, because of vastly improved communications and a rapidly expanding market, it became necessary for traders worldwide to quote rates in a uniform manner. As a result, American foreign exchange traders began using foreign currency units per dollar or "European Terms" for most rates. Using European terms, the quote in this example would be U.S.$1=CHF.64516. Thus, European terms represent the value of the U.S. dollar in units of the foreign currency. A quote in European terms is simply the reciprocal of a quote in U.S. terms. One major exception to this shift is the British pound sterling which, for historical purposes, is always quoted in U.S. terms such as 1£=$1.7450.)

Any commercial bank which maintains due from bank balances, commonly known as "nostro" accounts, in banks in foreign countries in the local currency has the capability of engaging in foreign exchange. The majority of U.S. banks restrict foreign exchange to the servicing of their customers' foreign currency needs. The banks will simply sell the currency at a rate slightly above the market and subsequently offset the amount and maturity of the transaction through a purchase from another correspondent bank at market rates. This level of activity involves virtually no exposure as currency positions are covered within minutes. A small profit is usually generated from the rate differential, but the activity is clearly designated as a service center.

Greater emphasis is placed on foreign exchange activity by regional banks. The servicing of the corporate customers' needs is also a priority, but most regional banks also participate in the interbank market. These banks look at the trading function as a profit center as well as a service. Such banks usually employ several experienced traders and, unlike the previous group, will take positions in given currencies based on anticipated rate movements.

Multinational banks assume, by far, the most significant role in the foreign exchange marketplace. While still servicing customer needs, these banks are heavily engaged in the interbank market and look to their foreign exchange trading operation for sizable profits. Such banks trade foreign exchange on a global basis through international branch networks.

A major aspect of any foreign exchange review is the ability of the examiner to determine if the bank has the capability to adequately handle the level of its foreign exchange volume and the extent of the exposures taken. This judgment is, by necessity, subjective; however, it must take into consideration asset size, capital base, customer volume in foreign exchange, depth and experience of traders, and management understanding of and commitment to trading. The fundamental principles of foreign exchange trading outlined below are designed to assist the examiner in this analysis.

SPOT TRADING

Buying and selling foreign exchange at market rates for immediate delivery represents spot trading. In reality, spot trades have a "value date'' (maturity or delivery date) of two to five business days (one for Canada and Mexico). Foreign exchange rates that represent the present market value for the currency are known as spot rates. The risk of spot trading results from rate movements occurring when the bank's position in foreign currency is not balanced with regard to exchange bought and sold. Such unbalanced positions are referred to as net open positions and are defined as follows:

Net Open Positions—A bank has a net position in a foreign currency when its assets, including spot and future contracts to purchase, and its liabilities, including spot and future contracts to sell, in that currency are not equal. An excess of assets over liabilities is called a net ''long'' position and liabilities in excess of assets a net ''short'' position. A ''long'' position in a foreign currency which is depreciating will result in an exchange loss relative to book value because, with each day, that position (asset) is convertible into fewer units of local currency. Similarly, a ''short'' position in a foreign currency which is appreciating represents an exchange loss relative to book value because, with each day, liquidation of that position (liability) will cost more units of local

CONSOLIDATED FOREIGN EXCHANGE POSITION, MAY 4, 20XX

Amounts in thousands

	Assets/Purchases		*Liabilities/Sales*	
Monetary Unit, Overnight Limit and Description	*Foreign Amount*	*U.S. $ Equivalent of Local Currency Book Value*	*Foreign Amount*	*U.S. $ Equivalent of Local Currency Book Value*
JAPANESE YEN ($3,000M)				
Ledger Accounts	563,437	239,461	645,013	274,310
Spot Contracts	23,502	9,802	15,973	6,709
Forward Contracts	790,250	331,905	712,533	296,342
	1,377,189	581,168	1,373,519	577,361
Net Position (long)	3,670	3,807		
CANADIAN DOLLARS ($6,000M)				
Ledger Accounts	1,016,076	1,017,525	1,029,835	1,030,057
Spot Contracts	330,021	328,972	216,225	217,246
Forward Contracts	1,202,013	1,203,226	1,301,279	1,302,522
	2,548,110	2,549,723	2,547,339	2,549,825
Net Position (long)	771			102
SWISS FRANC ($250M)				
Ledger Accounts[1]	31,768	11,932	36,052	13,571
Spot Contracts	1,526	593	2,566	969
Forward Contracts	11,174	4,274	6,545	2,521
	44,468	16,799	45,163	17,061
Net Position (short)[2]			695	262

1. Does not include a Swiss franc 1,000M (U.S. $386M) unhedged investment in a Swiss subsidiary and Swiss franc 573M (U.S. $217M) unhedged investment in branch fixed assets. The unhedged term ''long'' position was approved by senior bank management.

2. Net overnight position in excess of established limit. Formally approved as a special situation by senior management prior to the transaction.

currency. (Examples of net open position schedules appropriate for use in preparing the report of examination appear on the preceding page.)

It is important to remember that the net open position consists of both balance sheet accounts and contingent liabilities. For most banks, the nostro accounts represent the principal assets; however, foreign currency loans as well as any other assets or liability accounts denominated in foreign currency that are sizable in certain banks, must be included. All future foreign exchange contracts outstanding are contingents. When a contract matures, the entries are posted to a nostro account in the appropriate currency.

Each time a bank enters into a spot foreign exchange contract, its net open position is changed. For example, assume that Bank A opens its business day with a balanced net open position in pound sterling (assets plus purchased contracts equal liabilities plus sold contracts). This is often referred to as a "flat" position. Bank A then receives a telephone call from Bank B requesting a "market" in sterling. Because it is a participant in the interbank foreign exchange trading market, Bank A is a "market maker." This means it will provide Bank B with a two-sided quote consisting of its bid and offer for sterling. If a different currency was requested, European terms would be the opposite as the bid and offer would be for dollars instead of the foreign currency. In determining the market given, Bank A's trader of sterling will determine where the market presently is (from brokers and/or other banks) and attempt to anticipate where it is headed and whether Bank B is planning to buy or sell sterling.

When Bank A gives its quote on sterling, $1.7115–25 for example, it is saying that it will buy sterling (its bid) at $1.7115 or sell sterling at $1.7125 (its offer). If Bank B's interest is to buy sterling and the given quote is appealing, it will buy sterling from Bank A at $1.7125 (Bank A's offer of sterling). Note, that while Bank B may choose to buy, sell, or pass as it wishes, it must do business on the terms established by Bank A. These terms will be in Bank A's favor. As soon as Bank B announces it will purchase sterling at $1.7125, Bank A acquires a net open position (short) in sterling. Bank A must then decide whether to hold its short position (in anticipation of a decline in sterling) or cover its position. Should it wish to cover, it may call another bank and purchase the amount it sold to Bank B. However, in this case, as the calling bank, Bank A would buy its sterling from the offered side of the quote it receives and must buy it at $1.7125 or less to avoid a loss.

Banks engaging in interbank spot trading will often be involved with sizable net open positions, though many for just brief periods. No matter how skilled the trader, each will encounter at least occasional losses. Knowing when to close a position and take a small loss before it becomes large is a necessary trait for a competent trader. Many banks employ a "stop loss policy" whereby a net open position must be covered if losses from it reach a certain level. While a trader's forecast may ultimately prove correct within a day or week, rapid rate movements often force a loss within an hour or even minutes. Also, access to up-to-the-minute information is vital for involvement in spot trading. Banks who lack the vast informational resouces of the largest multinationals may be particularly vulnerable to sudden spot rate movements prompted by inside information or even rumors. As a result, examiners should closely review banks where foreign exchange activities consist primarily of interbank spot trading.

FORWARD TRADING

A forward transaction differs from a spot transaction in that the value date is more than two to five business days in the future. The maturity of a forward foreign exchange contract can be a few days, months, or even years in some instances. The exchange rate is fixed at the time the transaction is agreed. But nostro accounts are not debited or credited, i.e., no money actually changes hands, until the maturity date of the contract. There will be a specific exchange rate for each forward maturity, and each of those rates will generally differ from today's spot exhange rate. If the forward exchange rate for a currency is higher than the current spot rate, dealers say the currency is trading at a "premium" for that forward maturity. If the forward rate is below the spot rate, then the currency is said to be trading at a "discount." For instance, sterling for value in three months is at a discount if the spot rate is $1.75 and the three-month forward rate is $1.72.

Banks active in the foreign exchange market find that interbank currency trading for any specific value date in the future is inefficient and engage in it only infrequently. Instead, for future maturities, banks trade among themselves as well as with some corporate customers on the basis of a transaction known as a "swap." A swap transaction is a simultaneous purchase and sale of a certain amount of foreign currency for two different value dates. The key aspect is that the bank arranges the swap as a single transaction with a single counterparty, either another bank or a nonbank customer. This means that, unlike outright spot or forward transactions, a trader does not incur a net open position since the bank contracts both to pay and to receive the same amount of currency at specified rates.

A swap allows each party to use a currency for a period in exchange for another currency that is not needed during that time. Thus, the swap offers a useful investment facility for temporary idle currency balances of a corporation or a financial institution. Swaps also provide a mechanism for a bank to accommodate the outright forward transactions executed with customers or to bridge gaps in the maturity structure of its outstanding spot and forward contracts.

The two value dates in a swap transaction can be any two dates. But, in practice, markets exist only for a limited number of standard maturities. One of these standard types is called a "spot against forward" swap. In a spot against forward swap transaction, a trader buys or sells a currency for the spot value date and simultaneously sells or buys it back for a value date a week, a month, or three months later.

Another type of transaction of particular interest to professional market-making banks is called a "tomorrow-next" swap or a "rollover." These are transactions in which the dealer buys or sells a currency for value the next business day and simultaneously sells or buys it back for value the day after. A more sophisticated type of swap is called a "forward-forward" in which the dealer buys or sells currency for one future date and sells or buys it back for another future date. Primarily, multinational banks specialize in transactions of that type.

Any swap transaction can be thought of as if it were a simultaneous borrowing and lending operation. For example, on September 11, Bank A "swaps in" three-month sterling in a spot against a forward transaction with Bank B. On September 13, Bank A pays dollars to Bank B's account at a New York bank and Bank A receives sterling for its account at a bank in London. On December 13, the swap is reversed. Bank A pays back the sterling to Bank B, while B pays back the dollars to A. In the meantime, Bank A has the use of the sterling, in effect "borrowing" sterling, while giving up use of the dollars, in effect "lending" the dollars. Banks recognize this close equivalence to actual short-term borrowing and lending. Many fold in swap transactions with other money market transactions in managing their global banking activities.

Forward exchange rates can be expressed in three ways. Like spot rates, outright forward prices are expressed in dollars and cents per currency unit or vice versa. Traders normally only quote forward prices to corporate customers or to small correspondent banks seeking to buy or sell a currency for a particular future date. For instance, a trader may quote an outright six-month rate to buy sterling of $1.8450, while, by comparison, a quotation to buy spot sterling might be less ($1.8200) or more ($1.8625).

In swap transactions, the trader is only interested in the difference between spot and forward rates, the premium or discount, rather than the outright spot and forward rates themselves. Premiums and discounts expressed in points ($0.0001 per pound sterling or € 0.0001 per dollar) are called swap rates. For the first spot rate above, the premium is 250 points ($0.0250). For the second, the discount is 175 points ($0.0175).

Since, in a swap, a trader is effectively borrowing one currency and lending the other for the period between the two value dates, the premium or discount is often evaluated in terms of percent per annum. For the examples above, the premium of 250 points is equivalent to 2.75 percent per annum, while the discount of 175 points is equivalent to 1.88 percent per annum. To calculate the percentage premium for the first case:

- Take the swap rate ($0.0250)
- Multiply by 12 months and divide by 6 months (a per annum basis)
- Divide by the spot rate ($1.8200), and
- Multiply by 100 (to get a percent basis).

On a formula basis, this can be expressed as:

$$\text{\% per annum} = \left(\frac{\text{Premium or Discount} \times 12}{\text{Spot rate} \times \text{number of months of forward contract}} \right) \times 100$$

As can be seen from the above, forward rates (premiums or discounts) are solely influenced by the interest rate differentials between the two countries involved. As a result, when the differential changes, forward contracts previously booked could now be covered at either a profit or loss. For example, assume an interest rate differential between sterling and dollars of 3 percent (with the sterling rate lower). Using this formula, with a spot rate of $1.80, the swap rate on a three month contract would be a premium of 135 points. Should that interest rate differential increase to 4 percent (by a drop in the sterling rate or an increase in the dollar rate), the premium would increase to 180 points. Therefore, a trader who bought sterling three months forward sterling at 135 points premium could now sell it at 180 points premium, or at a profit of 45 points (expressed as .0045).

Thus, the dealer responsible for forward trading must be able to analyze and project dollar interest rates as well as interest rates for the currency traded. Additionally, because forward premiums or discounts are based on interest rates differentials, they do not reflect anticipated movements in spot rates.

Active trading banks will, of course, have a large number of forward contracts outstanding. The portfolio of forward contracts is often called a "forward book." As a result, these forward positions must be managed on a gap basis. Normally, banks will segment their forward books into 15-day periods and show the net (purchased forward contracts less sold ones) balance for each period. A typical forward book would look as follows:

Foreign Currency	*Maturity Date*	*Purchases*	*Sales*	*Net Position for Period*
England	Dec. 1–15	1 000 000	800 000	200 000
(amounts in)	16–31	700 000	900 000	(200 000)
pound sterling)	Jan. 1–15	1 500 000	500 000	1 000 000
	16–31	1 400 000	600 000	800 000
	Feb. 1–15	1 100 000	700 000	400 000
	16–28	1 400 000	400 000	1 000 000
	Mar. 1–31	200 000	1 300 000	(1 100 000)
	Apr. 1–30	400 000	1 600 000	(1 200 000)
	May 1–31	300 000	900 000	(600 000)
	June 1–30	350 000	450 000	(100 000)
	July 1–31	550 000	450 000	100 000
	Aug. 1–31	1 000 000	1 000 000	—
	Sept. 1–30	500 000	600 000	(100 000)
	Oct. 1–31	600 000	500 000	100 000
	Nov. 1–30	100 000	100 000	—
	Dec. 1–31	100 000	200 000	(100 000)
	Totals	11 200 000	11 000 000	200 000

In this forward book, volumes and net positions are limited with only the first three months segregated into 15-day periods with the remainder grouped monthly. The trader will use the forward book to manage his overall forward positions.

A forward book in an active currency may consist of numerous large contracts but, because of the risks in a net open position, total forward purchases will approximately equal total forward sales. (Note: In the above forward book, the net position is only £200,000.) What matters in reviewing a forward book is the distribution of the positions by period. In the above example, the forward sterling is long a net 3,200,000 for the first three months (December through February) and short a net 3,000,000 for the next four months (March through June). In this instance, the forward book is structured for an anticipated decline in dollar interest rates as compared with sterling interest rates since these sold positions could be offset (purchase of a forward contract to negate the sold forward position) at a lower price—either reduced premium or increased discount.

Trading forward foreign exchange thus involves projecting interest rate differentials and managing a forward book to be compatible with these projections. An understanding of these concepts is essential when looking at forward trading from risk and profitability aspects.

COMPUTING FOREIGN EXCHANGE PROFITS AND LOSSES

If traders did nothing but spot transactions and never took open positions from day to day, calculating profit or loss would be straightforward. For example: on January 21, the traders buy £1,000,000 spot at $1.75 and £3,000,000 at $1.74 and sell £2,000,000 at $1.7450 and £2,000,000 at $1.7380. On the spot value dates, two business days later, the bank's nostro or clearing account in London is credited and debited by £4,000,000 from the maturing transactions.

The sterling position is square, since debits and credits are equal. In New York, the bank pays $6,970,000 but receives only $6,966,000. There is a net loss of $4,000 on the four transactions. This is so because the bank's accountant would calculate that the traders acquired sterling at an average rate of $1.7425 =

$$\frac{\pounds 1{,}000{,}000 \times \$1.75 + \pounds 3{,}000{,}000 \times \$1.74}{\pounds 4{,}000{,}000}$$

Against that, the traders sold sterling at $1.7450, for a profit of $5,000 (i.e., $1.7450 $1.7425 = $0.0025 × 2,000,000 = $5,000). Traders also sold another £2,000,000 at $1.7380 for a loss of $9,000 ($1.7380 $1.7425 = $0.0045 × £2,000,000 = $9.000). In this instance, the computed net loss of $4,000 is precisely the same as the excess of dollar payments over dollar receipts.

In practice, computing profits and losses is far more complex for two basic reasons. Banks do not trade only for spot value—they also do forward contracts. Moreover, most major banks do not operate from day to day with completely square positions in each currency. Because of the way different forward contracts mature each day, it is unusual for payments and receipts to balance perfectly until the traders arrange swaps to achieve that result. Because some traders take a view about the future movements of a currency, short or long positions are built up; and, because of the changing influences on market developments and traders' decisions, long or short positions can be altered any number of times each and every day.

In this kind of fluid trading environment, a bank needs to establish accounting procedures for calculating profits and losses which can handle the problem of maturity mismatches and open foreign currency positions. The principles underlying the accounting procedures are much the same from bank to bank, although specific practices vary. The first principle is that banks do not formally calculate profits or losses daily; most compute profits and losses monthly. Some banks do make these calculations more frequently for management information purposes.

The next principle is that banks calculate profits or losses on the entire foreign exchange book as of the calculation date. On any day, the book includes all spot and forward contracts which have not yet matured, along with nostro balances in each currency. Each contract represents a purchase or sale of a foreign currency at a specified exchange rate.

On the profit calculation date, the bank's accountants revalue the foreign exchange book. They use the latest market exchange rates, spot and forward, for each value date on which contracts are outstanding. For each contract, the difference between the current market rate for the value date of the contract and the rate specified in the contract is calculated. For example, if the bank previously bought a currency, e.g., sterling at $1.75, and the current market rate for the relevant maturity is higher, e.g., sterling at $1.80, there is an unrealized profit.

These calculated unrealized profits and losses are amalgamated with the realized profits or rlosses that accrue every day as foreign exchange contracts mature. The net profit or loss, realized plus unrealized, is then incorporated in bank operating income, reflecting the net contribution of foreign exchange trading before expenses.

To recapitulate, a bank with a large number of spot and forward contracts and possibly with open positions in one or more currencies needs a formal method of computing unrealized profits and losses at regular intervals. It uses a revaluation procedure that, in effect, measures what the profits and losses would be if the bank covered in the market all outstanding positions that were not already covered. The revaluation procedure ensures that the bank's open positions show changes in exchange rates as they occur, rather than when open positions are eventually covered or when individual contracts mature. Periodic profit and loss calculations therefore provide bank management with ongoing insights into the performance of the trading function.

Following is an illustration of the revaluation procedure. Assume that on the revaluation date, January 15, Bank A had three outstanding contracts in its sterling book:

- A sale of £1,000,000 at $1.75 for value March 15.
- A purchase of £3,000,000 at $1.70 for value May 15.
- A sale of £1,000,000 at $1.65 for value August 15.

The book is "long" £1,000,000 since purchases of sterling are greater than sales. For now, the nostro account and the calculations of realized profits and losses are left aside.

To revalue the book, the accountants find on January 15 that two-month, four-month, and seven-month forward rates in the market are $1.80, $1.75, and $1.70, respectively. They proceed conceptually as if the traders were to cover the contracts at the going market rates, buying sterling to offset sales and selling sterling to offset purchases. On this basis, for the first contract, they compute an urealized loss of $50,000 ($1.75 $1.80 = $0.05 × £1,000,000). For the second contract, they compute an unrealized profit of $150,000 ($1.75 $1.70 = $0.05 × £3,000,000). For the third contract, they compute an unrealized loss of $50,000 ($1.65 $1.70 = $0.05 × £1,000,000). The net is an unrealized profit of $50,000 which is entered on the income statement as the trading profit.

The accountant's task actually is far more complicated. A foreign exchange book of a major bank may include hundreds of outstanding contracts in a dozen or more currencies. Value dates range from the next day to a year or more in the future. Market exchange rates are readily available for the "even" dates—one, two, three, six, twelve, and twenty-four months into the future. The Federal Reserve Bank of New York publishes such a daily series which can be used by bank accountants and examiners. But for "odd" dates, the accountant must approximate rates, possibly through a computer program that interpolates between even date quotations.

As contracts in the foreign exchange book mature, they affect the cash flow of the bank. Maturing purchase and sale contracts are treated asymmetrically. In a U.S. bank, which posts its profits and losses in dollars, maturing purchase contracts result in credits to its nostro account in that currency. Each day, the bank's accountants compute a new average acquisition rate for the nostro account based on existing holdings and all flows into the account that day. Maturing sale contracts result in debits to the nostro account. They yield a gain or loss measured against the average acquisition rate for funds available in the nostro account. The net realized profit or loss is placed in a suspense account which, at regular intervals, is incorporated into the bank's income statement along with the unrealized profits or losses resulting from the periodic revaluation of the foreign exchange book. In practice, the revaluation can be done on a worksheet as long as net positions for time periods and present market rates are known. While banks will revalue monthly and make the appropriate entries to income accounts, traders will spot-check their profitability more frequently. Examiners should understand the revaluation procedure for the necessary test checking of reported profits, as time restrictions do not normally allow for the proving of all of the bank's open positions.

To revalue the nostro accounts, which represent realized profit or loss, the net foreign currency balance is multiplied by the current spot rate and the result, or market value, is compared to the U.S. $ equivalent on the books to determine profit or loss as shown below:

Foreign Amount	*Spot Rate*	*Market Value*	*U.S. $ Equivalent Book Value of Ledger Accounts*	*Profit or Loss*

15,172	$1.7155	26,028	21,229	+4,799

The same principle holds true when comparing market value to book, even if credit balances exist. (A market value of -19.055 and a book value of -20,155 would result in a profit of 1,100.)

A worksheet revaluation of forward contracts, for unrealized profits, is an expansion of the forward book previously shown. All rates must be expressed in "U.S. terms."

FORWARD BOOK

Foreign Currency	*Maturity Date*	*Purchases*	*Sales*	*Net Position for Period*	*D-Discount P-Premium Rate*	*Profit*	*Loss*
England	Dec. 1–15	1 000 000	800 000	200 000	.0025 P	500	
	16–31	700 000	900 000	(200 000)	25 P		500
	Jan. 1–15	1 500 000	500 000	1 000 000	15 P	1,500	
	16–31	1 400 000	600 000	800 000	15 P	1,200	
	Feb. 1–15	1 100 000	700 000	400 000	5 P	200	
	16–28	1 400 000	400 000	1 000 000	5 P	500	
	Mar. 1–31	200 000	1 300 000	(1 100 000)	5 D	550	
	Apr. 1–30	400 000	1 600 000	(1 200 000)	15 D	1,800	
	May 1–31	300 000	900 000	(600 000)	30 D	1,800	
	June 1–30	350 000	450 000	(100 000)	45 D	450	
	July 1–31	550 000	450 000	100 000	5 P	50	
	Aug. 1–31	1 000 000	1 000 000	—	25 D	—	
	Sept. 1–30	500 000	600 000	(100 000)	0	—	
	Oct. 1–31	600 000	500 000	100 000	45 D		450
	Nov. 1–30	100 000	100 000	—	25 D	—	
	Dec. 1–31	100 000	200 000	(100 000)	5 P		50
	Totals	11 200 000	11 000 000	200 000		+7550	

In completing a worksheet in the above format, the following must be kept in mind:

- A long position at a premium = profit
- A short position at a premium = loss
- A long position at a discount = loss
- A short position at a discount = profit

The $7,550 is simply the profit that would be obtained if the forward book positions were fully liquidated at this time, i.e., purchases offset by sales. To calculate the profit, the unrealized profit from the previous month ($6,400 in this example) must be reversed. Thus, the sterling profit for this month would be:

$4,799	Nostro balance profit
7,550	Forward book profit (unrealized)
-6,400	Reversal of last month's forward book
$5,949	Sterling profit for the month

Most automated systems will eliminate the need for manual calculations. However, the resulting figure is only as accurate as the rates applied. As a result, examiners should test-check at least one major currency using independent rates (supplied by the Federal Reserve Bank of New York or another independent source). This should be done concurrently with the bank's own monthly revaluation. If a sizeable discrepancy results, rates and revaluation methods used by the bank should be reviewed with both management and the traders.

DEFINING AND CONTROLLING FOREIGN EXCHANGE RISKS

Foreign exchange trading encompasses a variety of risks. Exchange rate risk, maturity gaps and interest rate risk relate to spot and forward trading. The latter two risks relate to exposures inherent in all phases of international banking.

Exchange Rate Risk

Exchange rate risk is an inevitable consequence of trading in a world in which foreign currency values move up and down in response to shifting market supply and demand. When a bank's dealer buys or sells a foreign currency from another bank or nonbank customer, exposure from a net open position is created. Until the time that the position can be covered by selling or buying an equivalent amount of the same currency, the bank is exposed to the risk that the exchange rate might move against it. That risk exists even if the dealer immediately seeks to cover the position because, in a market in which exchange rates are constantly changing, a gap of just a few moments can be long enough to transform a potentially profitable transaction into a loss. Since exchange rate movements can readily accumulate in one direction, a position carried overnight or over a number of days entails greater risk than one carried a few minutes or hours. Again, the acid test of a good trader is to know when to take a small loss before it becomes larger.

At any time, the trading function of a bank may have long positions in some currencies and short positions in others. These positions do not offset each other, even though, in practice, some currencies do tend to move more or less together. The bank's traders recognize the possibility that the currencies in which they have long positions may fall in value and currencies in which they have short positions may rise. Consequently, gross trading exposure is measured by adding the absolute value of each currency position expressed in dollars. The individual currency positions and the gross dealing exposure must be controlled to avoid unacceptable risks.

To accomplish this, management limits the open positions dealers may take in each currency. Practices vary among banks, but, at a minimum, limits are established on the magnitude of open positions which can be carried from one day to the next (overnight limits). Several banks set separate limits on open positions dealers may take during the day. These are called "daylight" limits. Formal limits on gross dealing exposure also are established by some banks, while others review gross exposure more informally. The various limits may be administered flexibly, but the authority to approve a temporary departure from the norm is typically reserved for a senior officer.

For management and control purposes, most banks distinguish between positions arising from actual foreign exchange transactions (trading exposure) and the overall foreign currency exposure of the bank. The former includes the positions recorded by the bank's trading operations at the head office and at branches abroad. In addition to trading exposure, overall exposure incorporates all bank assets and liabilities denominated in foreign currencies including loans, investments, deposits, and the capital of foreign branches. Control of overall foreign currency exposure usually is the responsibility of a senior officer accountable to the bank's senior management.

Maturity Gaps and Interest Rate Risk

Interest rate risk arises whenever there are mismatches or gaps in the maturity structure of a bank's foreign exchange forward book. Managing maturity mismatches is an exacting task for a foreign exchange trader.

In practice, the problem of handling mismatches is involved. Eliminating maturity gaps on a contract-by-contract basis is impossible for an active trading bank. Its foreign exchange book may include hundreds of outstanding contracts. Some will mature each business day. Since the book is changing continually as new transactions are made, the maturity gap structure also changes constantly.

While remaining alert to unusually large mismatches in maturities that call for special action, traders generally balance the net daily payments and receipts for each currency through the use of rollovers. Rollovers simplify the handling of the flow of maturing contracts and reduce the number of transactions needed to balance the book. Reliance on day-to-day swaps is a relatively sound procedure as long as interest rate changes are gradual and the size and length of maturity gaps are controlled. However, it does leave the bank exposed to sudden changes in relative interest rates between the United States and other countries, which influence market quotations for swap transactions and, consequently, the cost of bridging the maturity gaps in the foreign exchange book.

The problem of containing interest rate risk is familiar to major money market banks. Their business often involves borrowing short-term and lending longer-term to benefit from the normal tendency of interest rates to be higher for longer maturities. But in foreign exchange trading, it is not just the maturity pattern of interest rates for one currency that counts. Rather, in handling maturity gaps, the differential between interest rates for two currencies is decisive. So the problem is more complex.

To control interest rate risk, senior management generally imposes limits on the magnitude of mismatches in the foreign exchange book. Procedures vary, but separate limits are often set on a day-to-day basis for contracts maturing during the following week or two and for each consecutive half-monthly period for contracts maturing later. At the same time, management relies on branch officers abroad, domestic money market experts, and its Economic Research Department to provide an ongoing analysis of interest rate trends.

Credit Risk

When a bank books a foreign exchange contract, it faces a risk, however small, that the counterparty will not perform according to the terms of the contract. In both instances, there is a credit risk, although, in the foreign exchange case no extension of credit is intended. To limit credit risk, a careful evaluation of the creditworthiness of the customer is essential. Just as no bank can lend unlimited amounts to a single customer, no bank would want to trade unlimited amounts of foreign exchange with one counterparty.

Credit risk arises whenever a bank's counterparty is unable or unwilling to fulfill its contractual obligations. That happens most blatantly when a corporate customer enters bankruptcy or a bank counterparty is declared insolvent. In any foreign exchange transaction, each counterparty agrees to deliver a certain amount of currency to the other on a particular date. Every contract is immediately entered into the bank's foreign exchange book. In balancing its trading position, a bank counts on that contract being carried out in accordance with the agreed upon terms. If the contract is not liquidated, then the bank's position is unbalanced and the bank is exposed to the risk of changes in the exchange rates. To put itself in the same position it would have been in if the contract had been performed, a bank must arrange for a new transaction. The new transaction may have to be arranged at an adverse exchange rate. The trustee for a bankrupt company may perform only contracts which are advantageous to the company and disclaim those contracts which are disadvantageous.

Another and potentially more pernicious form of credit risk stems from the time zone differences between the United States and foreign nations. Inevitably, a bank selling sterling, for instance, must pay pounds to a counterparty earlier in the day than it will be credited with dollars in New York. In the intervening hours, a company can go into bankruptcy or a bank can be declared insolvent. Thus, the dollars may never be credited.

Managing credit risk is the joint responsibility of the bank's trading department and its credit officers. A bank normally deals with corporations and banks with which it has an established relationship. Dealing limits are set for each counterparty and are adjusted in response to changes in its financial condition. In addition, some banks set separate limits on the value of contracts that may mature on a single day with a particular customer. Some banks, recognizing credit risk increases as maturities lengthen, restrict dealings with certain customers to spot transactions or require compensating balances on forward transactions. A bank's procedures for evaluating credit risk and minimizing exposure are reviewed by supervisory authorities as part of the regular examination process.

Transfer Risk

At one time or another, virtually every country has interfered with international transactions in its currency. Interference might take the form of regulation of the local exchange market, restrictions on foreign investment by residents, or limits on inflows of investment funds from abroad. Governments take such measures for a variety of reasons: to improve control over the domestic banking system, or to influence the pattern of receipts and payments between residents and foreigners. Restrictions on the exchange market or on international transactions generally are intended to affect the level or movement of the exchange rate.

Changes in regulations or restrictions usually do have an important exchange market impact. From the viewpoint of a commercial bank's foreign currency traders, most disruptive are changes in rules which interfere with the normal payments mechanism. Traders make foreign exchange contracts on the expectation that both parties will perform according to the terms of the contract. But if government regulations change and a counterparty is either forbidden to perform as expected or is required to do something extra, then a trader might be left with an unintended open position or an unintended maturity mismatch. As described in the previous section, dealing with unintended long or short positions can be costly.

Other changes in official regulations do not in the first instance, affect the payments mechanism, but they do influence international investment transactions. Consequently, when one of the factors affecting the buying or selling of a currency changes, the exchange rate is likely to respond. Currency traders usually try to limit open positions and maturity gap mismatches, whenever modifications in official regulations appear likely. Nevertheless, changes in controls often are unpredictable; and unanticipated changes in regulations can spark significant exchange rate response.

Monitoring and responding to changing official exchange controls abroad has to be done by a well-run foreign exchange trading function. Most U.S. banks have judged that the simplest approach is to avoid trading in those currencies for which the market is heavily regulated. This decision is reflected in turnover statistics which show that trading is concentrated in the major currencies subject to the fewest controls; generally the euro, Canadian dollar, British pound sterling, Swiss franc, and Japanese yen.

POLICY

The relative importance of each of those risk determinants varies with each currency traded and with the country of each counterparty. Senior bank management must fully understand the risks involved in foreign exchange and money market operations and must establish, in writing, its goals and policies regarding those risks. Management must be able to defend logically the basis upon which such policies are formed. It is imperative that responsible officers, traders, clerks and auditors fully understand the intent as well as the detail set forth in those directives.

At a minimum, policies should define dealing limits and reporting requirements as well as accounting and audit and control systems to provide for proper surveillance over those limits and exceptions thereto.

Limits must be established for overnight net positions in each currency. Depending on the size of the limits and the manner in which they are calculated, a smaller aggregate position limit for all currencies may be desirable. An aggregate limit should not permit the netting of short against long positions, but should require that they be added to determine conformance to that limit. Many U.S. banks consider whether to establish daylight (intraday) position limits only if efficient computerization and input systems are in effect to incorporate each trade into the appropriate currency position at nearly the precise moment it is transacted.

Gap (net inflow and outflow) limits must be instituted to control the risk of adverse rate movement and liquidity pressures for each currency for each daily, weekly, and biweekly future time frame designated in the bank's maturity reports. Such limits might range from stated absolute amounts for each time frame to weighted limits that emphasize increasing rate movement exposure applicable to the relative distance into the future in which the gap appears.

Aggregate trading and placement limits must be established for each customer, based primarily on the amount of business considered to be appropriate to its creditworthiness and, secondly, on the volume of its foreign currency needs. In addition, absolute sub-limits should be placed upon the amount of that customer's business that may be settled on one day. Should the customer be unable to meet obligations on one day, the trader will:

- Be forewarned against delivery prior to receipt of customer funds on the remaining contracts outstanding, and
- Have an opportunity to determine whether alternate cover must be obtained to meet

third-party transactions that may initially have provided cover for the remaining transactions with that customer.

It is difficult to monitor aggregate volume limits effectively and ensure compliance with settlement limits for a large number of customers. An effective settlement limit program for at least those relationships that possess a greater potential for late delivery or default should be enacted by senior management.

REPORTS

Properly designed reports are the most important supervisory tool available to management. They must be prepared in a concise, uniform, and accurate manner and submitted punctually. Management should receive daily net position reports for each currency traded. Normally, position reports should include all foreign currency balance sheet items and future contracts as well as afterhour and holdover transactions, excepting fixed assets and equity investments. The hedging of those investments is usually a management decision outside the normal responsibility of the traders. The reports should be prepared by the foreign exchange and money market bookkeeping section and reconciled daily to the trader's blotter. In the event that formal position reports cannot be submitted at the end of a business day, management should be apprised of the traders estimated position at the end of each day and especially before weekends and holidays.

Gap or maturity reports are essential to the proper management of a bank's liquidity in each foreign currency and significant maturity gaps may affect overall liquidity. Those reports should show daily gaps for at least the first two weeks to one month. Beyond that time, gap periods of a maximum of two weeks each are preferred. Gap reports are generally accurate only for the day on which they are prepared. Therefore, it is essential that banks have the capability to produce detailed management reports daily. Loans, deposits, and future contracts, as well as commitments to take or place deposits should be reflected in the periods in which they are scheduled for rollover or interest adjustment. In most instances, an additional report showing those items at final maturity is desirable in analyzing the bank's medium- and longer-term dependence on money market funding sources.

Exception reports must be promptly generated upon the creation of excesses to position limits, gap limits, and customer trading and settlement limits. Excesses over any established limits should conform to overall policy guidelines and should receive prior approval by the responsible supervisory officers. If prior approval is not possible, evidence of subsequent officer concurrence or disagreement as well as any corrective action should be available for audit review and management records.

REVALUATION AND ACCOUNTING SYSTEMS

Revaluation and accounting systems should be in place to accurately determine actual as well as estimated future profits and losses and to present them in such a manner as to facilitate proper income analysis by management, bank supervisory personnel, and the public. A bank's revaluation procedure should be test-checked at the time of monthly revaluation using independently obtained rates. While methods and systems may vary to some degree within banks, all revaluation systems should incorporate the following two aspects:

- Actual realized profit or loss as determined by applying current spot rates to balance sheet accounts as well as contracts of near maturities. Adjustments to the local currency book values would either be allocated and posted to each of the applicable local currency ledger accounts or, for short interim periods, be charged to a separate foreign exchange adjustment account with an offset to the profit and loss account.
- Unrealized (estimated future) profit or loss on future transactions as determined by applying the appropriate forward rates to the net positions shown for each future period appearing in the bank's gap or maturity reports. An account such as "estimated profit (loss) on foreign exchange—futures" should be charged or credited for the amount of the adjustment with an offset to the profit and loss account. Provided that the amount of that adjustment is the difference between the existing forward rates and the actual contract rates, each month's entries merely involves reversing the

adjustment from the prior revaluation and entering the new figures.

SPECIALIZED TRANSACTIONS

Financial Swaps

A financial swap is the combination of a spot purchase or sale against a forward sale or purchase of one currency in exchange for another. It is merely trading one currency (lending) for another currency (borrowing) for that period of time between which the spot exchange is made and the forward contract matures. The swap is the simple identification of one transaction contracted at the spot rate with another transaction contracted at the forward rate to establish the exchange cost or profit related to the temporary movement of funds into another currency and back again. That exchange (swap) profit or cost must then be applied to the rate of interest earned on the loan or investment for which the exchange was used. For example, the true yield of an investment for 90 days in United Kingdom Treasury bills cannot be determined without having considered the cost or profit resulting from the swap needed to make pounds sterling available for that investment. Likewise, the trading profits or losses generated by the trader cannot be determined if financial swap profits and expenses are charged to the exchange function rather than being allocated to the department whose loans or investments the swap actually funded.

Arbitrage

As it pertains to money markets and foreign exchange, arbitrage may take several forms. The creation of an open position in a currency in anticipation of a favorable future movement in the exchange rate, in addition to being speculative, is sometimes referred to as "arbitrage in time." Buying a currency in one market and simultaneously selling it for a profit in another market is called "arbitrage in space." Slightly more involved is the practice of interest arbitrage which involves the movement of funds from one currency to another so they may be invested at a higher yield. The real yield advantage in such a situation is not determined merely by the difference in interest rates between the two investment choices, but rather by subtracting the cost of transferring funds into the desired currency and back again (the swap cost) from the interest differential. For example, there is no arbitrage incentive involved in swapping from dollars into the other currency at a 60 point per month discount (swap cost) which exactly offsets the 3 percent gain in interest. However, should the swap rate move to 40 points per month (or 480 points per year), the investment might become attractive. This can be tested by converting the swap rate to an annual percentage rate:

$$\frac{\text{Discount or Premium} \times 360 \times 100}{\text{Spot rate} \times \text{No. of days of future contract}} = \%\ \text{P.A.}$$

$$\frac{.0040 \times 360 \times 100}{2.4000 \times 30} = 2\%\ \text{P.A.}$$

This results in a true yield incentive of 1 percent, 3 percent less the swap cost of 2 percent.

Unless the bank's accounting system can identify swap costs or profits and allocate them to the investments for which they were entered, both the earnings on those investments and the earnings upon which the trader's performance are measured will be misstated.

Options

Option contracts permit a bank to contract to buy from or sell to a customer when that customer can only generally predict the dates when the currency will be required. The option contract specifies the dates, and the rate cited is that which, in the judgment of the trader at the time of making the contract, contains the least exposure for the bank. This type of contract is commonly requested by commercial customers who wish to cover drafts drawn under letters of credit denominated in a foreign currency. Such contracts involve more risk as there is no way for the bank to acquire a precisely matching cover.

Compensated Contracts

There are occasions when both parties are agreeable to altering the terms of an existing contract. Such alterations should be approved by a bank officer without responsibilities in the trading room and the operations personnel must be advised of each compromise to avoid settlement in accordance with the original instructions and terms.

OTHER RELATED MATTERS

Departmental Organization and Control

It is imperative that there be a distinct separation of duties and responsibilities between the trading and the accounting and confirmation functions within the department. Many opportunities exist to avoid established limits and policies or for personal financial gain, whether by speculating beyond loosely controlled limits, concealing contracts because of poor confirmation procedures or by simple fraud. Periodic audits and examinations are no substitute for the existence of sound safeguards.

Supervision of Branches and Subsidiaries

Whether a bank maintains central control over all foreign-exchange and money market activities at the head office or elects to decentralize that control, the policies, systems, internal controls, and reporting procedures should not differ among separate offices within the bank.

The bank should be apprised of its worldwide positions by daily summary reports. Detailed net position and maturity gap reports should be received periodically in order to prepare consolidated positions, as required, and to monitor individual unit trading volume and funding methods.

Examination Objectives

Effective date March 1984

1. To determine if the policies, practices, procedures and internal controls regarding foreign exchange activities are adequate.
2. To determine if bank officers, traders and clerks are operating within the established guidelines.
3. To determine the extent of risk attributable to net open positions, maturity gaps and counterparty credit weakness.
4. To determine the scope and adequacy of the audit function.
5. To determine if the revaluation and accounting systems are adequate and accurately reflect the results of the trading operation.
6. To determine compliance with laws and regulations.
7. 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 foreign exchange section of the Internal Control Questionnaire.
2. Based on the evaluation of internal controls and the work performed by internal and external auditors, determine the scope of the examination.
3. Test for compliance with policies, practices, procedures and internal controls in conjunction with the remaining examination procedures. Also obtain a listing of any deficiencies noted in the latest review done by internal/external auditors, and determine if appropriate corrections have been made.
4. Obtain a trial balance, including local currency book values, of customer spot and future contract liabilities by customer and by maturities and:
   a. Agree or reconcile balances to appropriate subsidiary controls and to the general ledger.
   b. Review reconciling items for reasonableness.
5. Review foreign currency and appropriate local currency subsidiary control ledgers to determine that for each local currency entry there is an accompanying foreign currency entry unless they represent:
   a. Brokerage charges to the local currency ledger.
   b. Profit and loss adjustments to the local currency ledger.
   c. Correction of errors in either ledger.
6. Provide liability and other information on common borrowers to the examiner assigned to "International—Loans and Current Account Advances."
7. Identify those contracts with counterparties who are affiliates of or otherwise relatead to the bank, its directors, officers, employees, or major shareholders, and
   a. Compare the contracted rates with available rates for the same transaction date or with other similar contracts entered as of the same transaction date.
   b. Investigate any instances involving off-market rates.
8. Perform an independent revaluation of at least one major currency using rates obtained from independent sources, and compare results to the accounting department's monthly foreign exchange profit and loss entries.
9. Check the most recent revaluation workpapers and resultant accounting entries to determine that:
   a. Foreign currency amounts and book values were properly reconciled to subsidiary ledger controls.
   b. Rates used are representative of market rates as of revaluation date.
   c. Arithmetic is correct.
   d. Profit and loss results are separately recorded and reported to management for:
      - Realized profit or loss, i.e., that which is determined through the application of spot rates.
      - Unrealized (estimated future) profit and loss, i.e., that which is determined through the application of forward rates.
   e. Financial swap related assets, liabilities and future contracts are excluded from the normal revaluation process so that the results identified in step 9d reflect more accurately the trader's outright dealing performance.
   f. Financial swap related costs and profits are:
      - Amortized over the life of the applicable swap.
      - Appropriately accounted for as interest income and expense on loans, securities, etc. Test financial swap income and expense calculations and verify the accounting entries.
10. Review workpapers for selected revaluations performed since last examination. Testcheck and, if satisfied that they are accurate,
    a. Analyze combined realized earnings to determine that profits are commensurate with risks taken.
    b. Analyze monthly unrealized revaluation results (forecasts) to determine that:
       - The resulting amount for the last revaluation, if loss, is not large.
       - An increasing loss trend over previous revaluations does not exist. (Although month-to-month variations are not uncommon, an increasing unrealized loss trend could indicate that a trader is

caught in a loss position and is pursuing a notion that a negative trend in the exchange rate for that currency will reverse and, if combined with an ever multiplying increase in volume, might eventually be able to repay accumulated losses.)

11. Obtain the percentage of total contracts outstanding (dollar value of purchases plus sales that are with corporate customers). Analyze this percentage in regard to trend and comparison, if possible, to banks with similar trading volume. Ascertain if corporate volume is commensurate with written policy in regards to purpose and scope of the foreign exchange trading function.
12. Determine compliance with laws and regulations pertaining to foreign exchange activities by performing the following for Foreign Currency Forms FC–1, FC–1a, FC–2, and FC–2a:
    a. Obtain the most recently prepared monthly and weekly reports and review for accuracy.
    b. Select random bank-prepared daily net position reports for Wednesdays and month-end business days and test to see that:
       - Reports are being filed as required.
       - Reports are accurate.

       Be aware of instances in which net positions are generally large but reduced as of Wednesday and month-end reporting dates.
13. Discuss with appropriate officers and prepare in appropriate report format:
    a. Net position schedules.
    b. Maturity gap schedules.
    c. Frequent or sizeable excesses over any established limits.
    d. Any limits deemed excessive relative to:
       - Management's policy goals regarding the nature and volume of business intended.
       - The bank's capital structure.
       - The creditworthiness of trading counterparties.
       - Individual currencies which are subject to or are experiencing relatively sporadic rate changes.
       - Individual currencies for which limited spot and future markets exist.
       - Experience of traders.
       - The bank's foreign exchange earnings record.
    e. The absence of any limits deemed appropriate in present and foreseeable circumstances.
    f. Customers whose obligations are otherwise previously classified or intended to be criticized.
    g. Foreign exchange contracts which, for any other reason, are questionable in quality or ultimate settlement.
    h. Violations of laws and regulations.
    i. Deficiencies in internal controls.
    j. Other matters regarding the efficiency and general condition of the foreign exchange eepartment.
14. Update the workpapers with any information that will facilitate future examinations.

A review of the bank's internal controls, policies, practices and procedures regarding foreign exchange trading is essential to ensure no excessive risk or exposures exist. The bank's systems should be documented in a complete and concise manner and include, where appropriate, narrative descriptions, flowcharts, copies of forms used and other pertinent information. Items marked with an asterisk are particularly significant and require substantiation by observation or testing.

POLICIES

1. Has the board of directors, consistent with its responsibilities, adopted written policies governing:
   a. Trading limits, including:
      - Overall trading volume?
      - Overnight net position limits per currency?
      - Intra-day net position limits per currency?
      - Aggregate net position limit for all currencies combined?
      - Maturity gap limits per currency?
      - Individual customer aggregate trading limits, including spot transactions?
      - Written approval of excesses to above limits?

   b. Segregation of duties among traders, bookkeepers and confirmation personnel?
   c. Accounting and revaluation procedures?
   d. Management reporting requirements?
2. Do policies attempt to minimize:
   a. Undue pressure on traders to meet specific budgeted earnings goals?
   b. Undue pressure on traders, by account officers, to provide preferred rates to certain customers?

*3. Are traders prohibited from dealing with customers for whom trading lines have not been established?

4. Are all personnel, except perhaps the head trader, prohibited from effecting transactions via off-premises communication facilities?
5. Is approval by a non-trading officer required for all compensated transactions?
6. Do credit approval procedures exist for settlement (delivery) risk either in the form of settlement limits or other specific management controls?
7. Does a policy procedure exist to ensure that, in case of an uncertain or emergency situation, the bank's delivery will not be made before receipt of counterpart funds?
8. Do the above policies apply to all branch offices as well as majority-owned or controlled subsidiaries of the bank?
9. Does the bank have written policies covering:
   a. Foreign exchange transactions with its own employees?
   b. Foreign exchange transactions with members of its board of directors?
   c. Its traders' personal foreign exchange activities?
   d. Its employees' personal business relationships with foreign exchange and money brokers with whom the bank trades?

*10. Are the above policies understood and uniformly interpreted by all traders as well as accounting and auditing personnel?

TRADING FUNCTION

11. Is a trader's position sheet maintained for each currency traded?

*12. Does management receive a trader's position report at the end of each trading day?

*13. Does the trader's position report reflect the same day's holdover and after-hours transactions?

14. Are trader's dealing tickets prenumbered?
    a. If so, are records and controls adequate to ascertain their proper sequential and authorized use?

    *b. Regardless of whether or not prenumbered,
      - Are dealing tickets time date stamped, as completed, or
      - Are dealing tickets otherwise identified with the number of the resultant contract to provide a proper audit trail?

ACCOUNTING AND REPORTING

*15. Is there a definite segregation of duties, responsibility and authority between the trading room and the accounting and reporting functions within the division and/or branch?

16. Are contract forms prenumbered (if so, are records and controls adequate to ensure their proper sequential and authorized use)?

17. Are contracts signed by personnel other than the traders?

*18. Are after-hours or holdover contracts posted as of the dates contracted?

*19. Do accounting personnel prepare a daily position report, for each applicable currency, from the bank's general ledger and:
   a. Do reports include all accounts denominated in foreign currency?
   b. Are those reports reconciled daily to the trader's position reports?
   c. Are identified or unreconciled differences reported immediately to management and to the head trader?
   d. Are all counterparty non-deliveries on expected settlements reported immediately to management and to the head trader?

*20. Are maturity gap reports prepared for liquidity and foreign exchange managers at least biweekly to include:
   a. Loans and deposits reflected in the appropriate forward maturity periods along with foreign exchange contracts?
   b. Loans, deposits and foreign exchange contracts (specify whether reflected in the maturity periods in which they fall due or in which they are scheduled for rollover ___________)?
   c. Commitments to accept or place deposits reflected in the appropriate maturity periods by both value and maturity dates?
   d. All those items (specify whether as of the day on which they mature or bi-weekly or monthly maturity periods ___________)?
   e. All those items as of the day on which they mature, if necessary, i.e., in the event of a severe liquidity situation?

*21. Does the accounting system render excesses of all limits identified at step 1 immediately to appropriate management and is officer approval required?

*22. Are local currency equivalent subsidiary records for foreign exchange contracts balanced daily to the appropriate general ledger account(s)?

*23. Are foreign exchange record copy and customer liability ledger trial balances prepared and reconciled monthly to subsidiary control accounts by employees who do not process or record foreign exchange transactions?

24. Do the accounting and filing systems provide for easy identification of ''financial swap'' related assets, liabilities and future contracts by stamping contracts or maintaining a control register?

CONFIRMATIONS

25. Is there a designated ''confirmation clerk'' within the accounting section of the division or branch?
   *a. Incoming confirmations:
      • Are incoming confirmations delivered directly to the confirmation clerk and not to trading personnel?
      • Are signatures on incoming confirmations verified with signature cards for:
         — Authenticity?
         — Compliance with advised signatory authorizations of the counterparty?
      • Are all data on each incoming confirmation verified with file copies of contracts to include:
         — Name?
         — Currency denomination and amount?
         — Rate?
         — Transaction date?
         — Preparation date if different from transaction date?
         — Maturity date?
         — Delivery instructions, if applicable?
      • Are discrepancies directed to an officer apart from the trading function for resolution?
      • Is a confirmation discrepancy log or other record maintained to reflect the identity and disposition of each discrepancy?

- Are telex tapes retained for at least 90 days as ready reference to rates and delivery instructions?

*b. Outgoing confirmations:
- Are outgoing confirmations mailed/telexed on the day during which each trade is effected?
- Are outgoing confirmations addressed to the attention of persons other than trading personnel at counterparty locations?
- Does the accounting and/or filing system adequately segregate and/or identify booked contracts for which no incoming confirmations have been received?
- Are follow-up confirmations sent by the confirmation clerk if no corresponding, incoming confirmation is received within a limited number of days after the contract is effected (if so, specify ___________)?
- Is involvement by the auditing department required if no confirmation is received within a limited number of days after the transmittal of the second request referred to above (if so, specify ___________)?
- Are confirmation forms sent in duplicate to customers who do not normally confirm?
- Are return copies required to be signed?

REVALUATIONS

*26. Are revaluations of foreign currency accounts performed at least monthly?

a. Does the revaluation system provide for segregation of and separate accounting for:
- Realized profits and losses, i.e., those which are determined through the application of spot rates?
- Unrealized profits and losses, i.e., those which are determined through the application of forward rates?

b. Are financial swap related assets, liabilities and future contracts excluded from the revaluation process so that the results identified in step 26a above more accurately reflect the trader's outright dealing performance?

c. Are financial swap costs and profits:
- Amortized over the life of the applicable swap?
- Appropriately accounted for as interest income and expense on loans, securities, etc?

d. Are rates provided by, or at least verified with, sources other than the traders?

OTHER

*27. Is the bank's system capable of adequately disclosing sudden increases in trading volume by any one trader?

28. Do such increases require officer review to insure that the trader is not doubling volume in an attempt to regain losses in his or her positions?

29. Does the bank retain information on, and authorizations for, all overdraft charges and brokerage bills within the last 12 months?

30. Does an appropriate officer review a comparison of brokerage charges, monthly, to determine if an inordinate share of the bank's business is directed to or handled by one broker?

CONCLUSION

31. 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.

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

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Effective date September 1992

Section 7110.1

The prospects for full LDC debt repayment decreased during the mid-1980s because of depressed commodity prices and inflated interest rates. The market value of public and private sector LDC loans fell sharply below book value to the point where those loans became deeply discounted. A secondary market for trading LDC debt evolved and reached a degree of maturity in 1987 when banks significantly increased their loan loss reserves for their exposures to LDCs. Financial institutions in the United States and overseas, including commercial, merchant and investment banks, began to actively purchase, sell, swap and rent debt obligations of less developed countries for their own account and as intermediaries for others. U.S. multinational banks with significant LDC loan exposures established LDC trading units which initially had the primary responsibility to decrease the banks' LDC portfolios. As the secondary market matured, these units not only traded for their own accounts but became market makers and/or active participants in purchasing, selling, swapping and renting LDC debt. An options market based on LDC debt also is emerging.

The LDC debt market, once dismissed as illiquid, has evolved from a trickle of activity between 1985 through 1988, to a turnover of approximately $100 billion during 1990. This momentum is expected to continue as participants in this market have realized the potential for generating substantial profits in trading LDC debt. The majority of this paper is Latin American, followed by Eastern European and African obligations. Debt of approximately 30 countries in 300 instruments may be handled by an active participant.

The LDC trading arena includes a broad range of counterparties. Although multinational banks with significant LDC debt exposures are the most active participants in the market, the number of intermediaries and principals has grown substantially. International financial institutions, corporations, high net worth individuals and public sector entities are primarily engaged in buying, selling and renting LDC debt for their own account.

The price of LDC paper, which is almost always at a discount from face amount, may vary widely, depending on the issuer and maturity of the instrument and the country of risk. Prices (and liquidity) in the LDC debt market are influenced by a multitude of factors such as the ability/intent of public and private sector borrowers to service the debt, availability of debt-equity exchange programs, anticipated refinancing of existing debt programs and the underlying political and economic conditions in the developing countries.

Banks generally participate in this market to decrease their LDC exposures; however, some banks are also motivated to:

- Generate trading profits from the spread between the bid and offer prices
- Produce fee and commission revenues from acting as intermediaries for principals and brokers
- Participate in swap programs to facilitate debt/equity market development

Pricing, liquidity, potential conflicts of interest, violation of U.S. and foreign country laws and operational inefficiencies are the major problems faced by banks which are active market participants. The lack of liquidity in the secondary market for LDC paper could present a variety of risks to market participants. In the absence of depth in the market, the judgement of the trader is a significant factor in determining the current price of thinly traded issues. The reliance on one individual to determine prices and using those amounts to revalue the position, could result in under or overstating the profit and loss and the valuation of the position itself. A conflict of interest could result in potential future liability if there is no clear segregation of duties and responsibilities between a bank's trading in LDC assets and its role on debt renegotiation committees.

Access to LDC debt rescheduling information could give a bank unfair advantage over other creditor banks, which do not participate in the restructuring process. Another concern is the potential for a bank or its employees to knowingly or inadvertently violate U.S. or foreign country laws or aid or abet violations by its customers or trading partners. It is clear that banks have a responsibility to determine that they deal only with reputable counterparties. The relative newness of the market and the absence of industry guidelines pose challenges to both bank managements and the bank supervisory agencies.

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets
Examination Objectives
Effective date September 1992

Section 7110.2

The objectives of conducting an examination of LDC asset purchases, sales, trading, swaps, rentals and options should include the following:

1. To determine if LDC asset purchases, sales, trading, swaps, rental and options policies, procedures and internal controls are adequate.
2. To evaluate the ability of the bank's reporting system to adequately monitor compliance to established policies, procedures and limits.
3. To review the bank's reporting system to determine whether it is adequate and effective.
4. To ascertain, to the extent possible, whether LDC trading activities are in compliance with applicable U.S. and local foreign laws.
5. To determine the extent of involvement by committees responsible for LDC trading activity in strategy and planning. For example, have contingency plans been developed if the need arises to liquidate a portfolio of LDC paper.
6. To identify potential conflicts of interest liability between those on committees for debt renegotiations or those acting as agents for the debtor country and those on the portfolio sales personnel and LDC debt traders.
7. To determine whether accounting procedures that have been established properly identify and account for loan sales, purchases, swaps, rentals and other LDC trading activity. Compare these accounting procedures to industry practices.
8. To ascertain that outstandings and traders' positions are reconciled to the official records of the bank.
9. To evaluate the LDC asset purchases, sales, trading, swaps or rentals for profitability.
10. To review the revaluation process utilized in determining profitability.
11. To determine the adequacy of the bank's risk management as it relates to LDC activities. Evaluate the bank's ability to monitor and control the following risks:
    a. Market risk
    b. Credit risk
    c. Settlement risk
    d. Liquidity risk
    e. Operational risk
    f. Legal risk
12. To review and assess the adequacy of the audit coverage with respect to the frequency and scope of the audit program, experience of auditors, quality of audit reports and effectiveness of management follow-up. Determine the extent of the outside accountants involvement in reviewing these activities.
13. To determine if sufficient legal documentation exists to establish an enforceable agreement, and to ascertain the nature of and purpose behind the underlying transaction.
14. To review the bank's procedures for conducting due diligence on nonbank parties.
15. To determine the sufficiency of the bank's transaction files.
16. To determine if the bank allows sales, borrowing or substitutions from its loan portfolio to its trading positions. If yes, how is the pricing on the loan portfolio done? Does the bank have the proper accounting and tracking procedures in place?
17. To review any unusual charges/fees and any split of fees or unusual destination of a payment.
18. To review margin lending practices and policies of banks offering financing to customers dealing in LDC debt.
19. To review bank's policies and procedures regarding traders' ability to trade in LDC debt for their own personal account to ensure that adequate controls are in place to avoid conflicts of interest and diversion of bank's corporate opportunities to traders' personal benefit.

International—Purchases, Sales, Trading, Swaps, Rentals, and Options of LDC Assets

Examination Procedures

Effective date September 1992

Section 7110.3

An examination of a bank's LDC asset purchases, sales, trading, swaps, rental, and options program should focus on written policies, accounting, management reporting, conflict of interest, risk management, and internal controls. In addition, the examiners should address the general nature, volume and importance of these activities.

1. Evaluate the adequacy of the bank's written policies regarding its LDC trading activity and determine whether:
   a. The objectives, strategy and philosophy adhere to those approved by the bank's board of directors.
   b. All documentation and legal requirements (both local and foreign) regarding this activity have been addressed.
   c. An approval process has been established to execute unusual or complex transactions in LDC paper that lacks liquidity or has some unusual feature.
   d. The policy stipulates the options available if the need arises to remove the asset from inventory.
2. Review the bank's accounting policy for LDC transactions.
   a. Review the accounting and reporting guidelines to assure that all aspects of this activity are captured on the books of the bank.
   b. Review the subsidiary ledgers and reconcile these with the general ledger and contingent accounts.
   c. Reconcile the traders position sheet with the general ledger accounts.
   d. Review the accounting procedures governing the bank borrowing LDC debt from its own portfolio and purchasing or borrowing from a third party.
   e. Determine if the revaluation process is conducted separately from the trading process and that the resultant gains or losses are properly recorded.
3. Determine whether the bank has addressed the "conflict of interest" issue sufficiently, so that trading activities are not being influenced by other areas of the bank that may be negotiating debt restructuring activities or that may have provided advice to such country on financial or economic matters. Are the same individuals participating as members of a debt renegotiating committee or acting in an agency capacity for the debtor country also involved in or communicating with those trading, swapping and renting LDC debt?
   a. Does the policy address all the roles that the bank performs? Has management established procedures to identify the responsibility of renegotiating committee members, agency personnel, portfolio sales personnel and LDC debt traders?
4. Review the bank's procedures to ensure that it is complying with local and sovereign laws.
   a. Is the bank aware of local and foreign laws governing the trading of a particular country's debt? Are there records demonstrating that legal personnel are reviewing transactions to determine compliance with U.S. and foreign laws? To what extent is this information disseminated to traders?
   b. Is the bank assuring itself that trading partners are not violating these laws or are using the bank to circumvent compliance with applicable laws and regulations?
5. Evaluate management's understanding of the risks associated with LDC asset purchases, sales, trading, swaps, options and rentals. Determine whether all risks have been considered and assess management's ability to monitor and control them. The following risks should be considered:
   a. *Market Risk*—The relevant risk interval for counterparty exposure is the time period from trade date to final settlement date. The exposure is a function of the change in the price during the risk interval. Determine how the bank monitors and controls its exposure to an increase in price, if it is buying, and decrease in price, if selling.
   b. *Credit Risk*—Does the bank require credit approval from appropriate lending officers for each counterparty? Review counterparty credit lines for proper approval.

Review margin lending practices as related to LDC debt sales.

c. *Settlement Risk*—While it occurs only when purchasing LDC assets, examiners should determine how the bank protects itself from this risk.
d. *Liquidity Risk*—Have restrictions been placed on dealing in LDC debt which is not actively traded?
e. *Operating Risk*—Review the bank's policies and procedures for deficiencies. Assure that all operating groups supporting this activity are adhering to established guidelines.
f. *Legal Risk*—Has counsel reviewed all segments of this activity from a legal perspective?

6. Determine whether the bank's LDC trading activities are subject to regular audits.
   a. Obtain copies of all recent audits and review their findings;
   b. Determine whether the audit procedures covering these activities are sufficiently comprehensive; and
   c. Determine whether management has taken appropriate action to resolve significant audit concerns.
7. Evaluate the bank's internal control policies and procedures with emphasis on:
   a. Are traders' lines and LDC debt limits established by country, type of paper and customer?
   b. Are limits established by credit officers who are independent of the LDC trading function?
   c. Determine that exceptions to established limits have been properly reported and approved.
8. Evaluate the policies and procedures governing traders' behavior:
   a. What type of controls are in place with regard to after hour trading?
   b. Describe the bank's procedures for recording phone conversations. Are traders permitted to override the recording devices? How long are these recordings retained?
   c. Describe the bank's policy regarding traders' remuneration.
   d. What types of procedures and policies have the bank implemented to address self-dealing in LDC debt by traders?
   e. In what manner are the traders educated about the bank's policies and procedures?
9. Describe the type of LDC transactions entered into by the bank:
   a. Does the bank engage in fronting (i.e., sales of participations, etc.) transactions? When engaging in fronting transactions, does the bank conduct the proper legal analysis regarding whether such transaction would violate any U.S. or foreign laws or restructuring agreements? Does the bank inquire as to the customer's purpose for acquiring LDC debt in fronting transactions?
   b. Does the bank engage in parking transactions through a third party or another banking unit? Does the bank permit other financial institutions to park debt with it?
10. Evaluate the private banking unit/group's involvement in LDC transactions:
    a. How are the private banking clients obtained?
    b. What types of LDC transactions does the bank enter into for its private banking clients? Does the bank inquire as to purpose of transactions entered into for private banking clients?
    c. What type of scrutiny is performed to assure that the bank "knows its private banking clients?"
11. Describe the types of fees which the bank pays when engaging in LDC transactions:
    a. What are the amounts of broker fees? Are these fees easily determinable? Are these fees in line with the industry practices?
    b. Does the bank have any other type of fee arrangements (i.e., specially negotiated fees, partnerships, etc.)?
    c. Has the bank diversified its use of brokers adequately?
12. Evaluate broker involvement in the LDC trading activity and review the fee structure on transactions.

8000—STATUTES ADMINISTERED BY THE FEDERAL RESERVE

The 8000 series provides a table of statutes and regulations that apply to the Federal Reserve System and to banking institutions that the Federal Reserve Board supervises and regulates. The table provides the name of the law, as enacted by Congress, and the section of the United States Code where the statute can be found. The table includes a summary of the particular section of the statute as well as the implementing regulation from the *Code of Federal Regulations* (CFR).

Following is a table of statutes and regulations that apply to the Federal Reserve System and to banking institutions that the Federal Reserve Board supervises and regulates. The table consists of five columns:

Statute. The name of the law as enacted by Congress and the section.

U.S. Code citation. The section of the United States Code where the statute can be found.

Description. A summary of the particular section of the statute.

FRB regulation. The implementing regulation, usually the Federal Reserve regulation, and the appropriate citation from the Code of Federal Regulations (CFR).

FRRS locator number. The location of the statute, regulation, or other reference in the *Federal Reserve Regulatory Service* (FRRS).

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Election Campaign Act	2 USC 441b	Limits political contributions by member banks.		
Foreign Gifts and Decorations Act	5 USC 7342	Restricts Board members' and employees' acceptance of foreign gifts and decorations.	Rules Regarding Foreign Gifts and Decorations, 12 CFR 264b	8-610 et seq.
Federal Reserve Act, sec. 10, para. 8	12 USC 1	Issuance of national currency and Federal Reserve notes under general supervision of FRB.		1-084
National Bank Act, as amended by the Banking Act of 1935	12 USC 51b-1	Impairment of the capital of national banks and state member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.4	1-307 3-159
National Bank Act, as amended by the Banking Acts of 1933 and 1935	12 USC 71a	Specific criteria for director selection and qualification for national banks and state member banks.		1-292
Emergency Banking Act of 1933, sec. 4	12 USC 95	Provides the president with power to require member banks to suspend operations during an emergency period.		1-323
Trading with the Enemy Act, sec. 5	12 USC 95a	Provides the president with wartime powers over banking.		1-440 1-441

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Federal Reserve Act, sec. 1; Banking Act of 1933, sec. 2	12 USC 221, 221a	Definition of basic terms in Federal Reserve Act, including "bank" and "affiliate."		1-002 1-309
Federal Reserve Act, sec. 2, paras. 1, 2, 3, and 13	12 USC 222–225, 281–282	Federal Reserve Bank organization; requirement that all national banks be members.		1-004 et seq. 1-016
Federal Reserve Act, sec. 2A, para. 1	12 USC 225a	Requires Federal Reserve and the Federal Open Market Committee to— • maintain long-run growth of the monetary and credit aggregates to advance the economy's long-run potential; and • report semiannually to each house of Congress on monetary and credit aggregate ranges.	Open Market Operations of Federal Reserve Banks, 12 CFR 270	1-017 8-823 et seq.
Federal Reserve Act, sec. 10, paras. 1–7 and 10	12 USC 241–247a	Creation and organization of Board of Governors; qualifications; terms of office; vacancies; assessments on Federal Reserve Banks; construction of Federal Reserve Board building; annual report to Congress; record of FOMC actions.	Rules of Organization	1-077–1-083 1-086 8-000 et seq.
Federal Reserve Act, sec. 11	12 USC 248	Powers of the Board of Governors.		1-091 et seq.
Federal Reserve Act, sec. 11(a)(1)	12 USC 248(a)(1)	Authorizes Board to examine and require reports of Reserve Banks and member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-092 3-150 et seq.
Federal Reserve Act, sec. 11(a)(2)	12 USC 248(a)(2)	Authorizes Board to require reports from any depository institution as necessary or desirable for monetary control purposes.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204.3	1-092 2-159 et seq.
Federal Reserve Act, sec. 11(b)	12 USC 248(b)	Authorizes Board to permit Federal Reserve Banks to rediscount paper of other Federal Reserve Banks and to fix rates of interest for rediscounted paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-093 2-001 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 11(c)	12 USC 248(c)	Authorizes Board to suspend reserve requirements.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204	1-094 2-122 et seq.
Federal Reserve Act, sec. 11(d)	12 USC 248(d)	Authorizes Board to supervise and regulate the issue and retirement of Federal Reserve notes through the OCC.		1-095
Federal Reserve Act, sec. 11(m)	12 USC 248(m)	Authorizes Board to fix the percentage of individual member bank capital and surplus that may be represented by loans secured by stock or bond collateral. Limits amount of loans secured by nongovernmental stock or bond collateral to any individual to 15% of bank's capital and surplus.		1-104
Federal Reserve Act, sec. 16, para. 14	12 USC 248-1	Authorizes Board to promulgate regulations for the transfer of funds between Reserve Banks, and to act as or designate Reserve Banks to act as clearinghouses.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfer Through Fedwire, 12 CFR 210; fee schedules and pricing policies for Federal Reserve Banks	1-153 9-775 et seq.
Federal Reserve Act, sec. 11(e)–(*l*)	12 USC 248(e)–(*l*)	Authorizes Board to regulate the affairs of the various Reserve Banks, to delegate its responsibilities to the Reserve Banks, and to hire employees to carry out the Board's business.	Rules Regarding Delegation of Authority, 12 CFR 265	1-096 et seq. 8-102 et seq.
Federal Reserve Act, sec. 11A	12 USC 248a	Requires Federal Reserve to price various services provided by Reserve Banks to depository institutions (e.g., check-collection services, wire transfer of funds, etc.).	Fee Schedules and Pricing Policies for Federal Reserve Banks	1-105 1-105.1
Federal Reserve Act, sec. 11B	12 USC 248b	Requires annual independent audit of financial statements of Federal Reserve Board and Banks.		1-105.5
Federal Reserve Act, sec. 12, paras. 1 and 2	12 USC 261–262	Federal Advisory Council, creation and powers.		1-106 1-107

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 12A	12 USC 263	Federal Open Market Committee, creation and powers. Federal Reserve Banks are required to comply with directives.	Federal Open Market Committee, 12 CFR 270–272	1-108 et seq. 8-800 et seq.
Federal Reserve Act, sec. 5, 6, paras. 1 and 2, and sec. 7	12 USC 287–290	Provisions regarding the issuance and cancellation of, and dividends on, Federal Reserve Bank stock.	Reg I, Issue and Cancellation of Capital Stock of Federal Reserve Banks, 12 CFR 209	1-045 et seq. 3-460 et seq.
Federal Reserve Act, sec. 4, paras. 6–22 and 24	12 USC 301–308	Selection, eligibility, duties, and powers of Federal Reserve Bank directors.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	1-026–1-044 8-168 et seq.
Federal Reserve Act, sec. 4, para. 8	12 USC 301	Suspension of any member bank from use of Federal Reserve credit facilities for undue use of bank credit for speculation or any purpose inconsistent with maintenance of sound credit conditions.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201.6(b)	1-028 2-014
Federal Reserve Reform Act of 1977	12 USC 302	Establishes standards for selection of certain Reserve Bank directors.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	1-030-1-032
Federal Reserve Act, sec. 9, paras. 1–5	12 USC 321–323	Eligibility requirements for membership in the Federal Reserve System and prohibition against establishment of branch except as authorized for national banks under National Bank Act. Authorizes Board to establish rules and regulations and impose conditions regarding membership.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-054 et seq. 3-150 et seq.
		Provides limits for standby letters of credit and ineligible acceptances and requires disclosure of amount of such credit.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.24	3-211 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 9, para. 6	12 USC 324	Applies to state member banks provisions of National Bank Act prohibiting national bank from lending on or purchasing its own stock (as provided in 12 USC 83, Rev. Stat. 5201) and relating to the withdrawl and impairment of the capital stock or payment of dividends (12 USC 55, Rev. Stat. 5205; 12 USC 56, Rev. Stat. 5204; and USC 60, Rev. Stat. 5199). Also authorizes Board to require filing and publication of reports of condition, income, and dividends.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208	1-509 3-150 et seq.
Federal Reserve Act, sec. 9, paras. 7 and 8	12 USC 325–326	Subjects member banks to examination by the Board. Also provides for acceptance of examinations conducted by state authorities.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.64	1-060 1-061 3-380
Federal Reserve Act, sec. 9, paras. 9 and 10	12 USC 327–328	Forfeiture of membership in the System. Withdrawal and cancellation of membership.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(f); Reg I, Issue and Cancellation of Capital Stock of Federal Reserve Banks, 12 CFR 209.3	1-062 1-063 3-158 3-463 3-464
Federal Reserve Act, sec. 9, paras. 11 and 12	12 USC 329	Capital requirements for membership including requirement that state member bank have capital at least equal to that of a national bank under 12 USC 51, Rev. Stat. 5138, and 12 USC 51b-1. Prohibition on reduction of capital stock without prior Board approval.	Reg H, Membership of State Banking Institutions in the Fed eral Reserve System, 12 CFR 208.4	1-064 1-065 3-159
Federal Reserve Act, sec. 9, para. 13	12 USC 330	Laws to which member banks are subject. Provisions regarding the discount of paper of state member bank.		1-066
Federal Reserve Act, sec. 9, para. 14	12 USC 331	Prohibits member bank certification of checks drawn on an account with insufficient funds.		1-067

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 9, para. 15	12 USC 332	Provisions authorizing member banks to act as depositaries of public monies.		1-068
Federal Reserve Act, sec. 9, para. 16	12 USC 333	Membership requirements for mutual savings banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(a)	1-069 3-154
Federal Reserve Act, sec. 9, paras. 17–19	12 USC 334	Reporting requirements for affiliates of member banks and civil money penalty for failure to file.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(e)	1-070–1-072 3-158
Federal Reserve Act, sec. 9, para. 20	12 USC 335	Applies to state member banks the restrictions and prohibitions in National Bank Act regarding the purchase, sale, underwriting, and holding of investment securities and stock (12 USC 24, Seventh, Rev. Stat. 5136).	Reg H, Membership of State Banking Institutions in the Fed eral Reserve System, 12 CFR 208.21(b)	1-073 3-202
Federal Reserve Act, sec. 9, para. 21	12 USC 336	Prohibits stapling of stock of a state member bank to that of another corporation.		1-074
Federal Reserve Act, sec. 9, para. 22	12 USC 338	Authorizes Board to examine the affairs of affiliates of state member bank. Refusal to permit examination may cause forfeiture of membership.		1-075
Federal Reserve Act, sec. 9, para. 23	12 USC 338a	Allows state member banks to make investments designed primarily to promote the public welfare.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.22	1-075.1 3-203 et seq.
Federal Reserve Act, sec. 9A	12 USC 339	Prohibits state member banks from participating in lotteries.		1-076
Federal Reserve Act, sec. 4, paras. 4 and 5	12 USC 341	Federal Reserve Bank powers and duties.		1-024 1-025

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 13, para. 1	12 USC 342	Authorizes Federal Reserve Banks to receive and collect deposits, checks, drafts, notes, and bills. Also allows member and nonmember banks or other depository institutions to assess reasonable charges, to be determined and regulated by the Board, for collection of checks and other items and transfer of funds.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire, 12 CFR 210	1-111 9-775 et seq.
Federal Reserve Act, sec. 13, paras. 2–6, 8, 10, 12–14; and sec. 13A, paras. 1–5	12 USC 343–352	Federal Reserve Bank discount and rediscount authority; authorizes Reserve Banks to lend to depository institutions that pledge acceptable collateral and to make advances to member banks, depository institutions, branches and agencies of foreign banks, individuals, partnerships, and corporations. Also authorizes Reserve Banks to discount agricultural paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-112–1-116 1-118 1-120 1-122–1-123.1 1-124–1-128 2-001 et seq.
Federal Reserve Act, sec. 14(g)	12 USC 348a	Authorizes Board to exercise supervision over all relationships and transactions between Reserve Banks and foreign banks and bankers.	Reg N, Relations with Foreign Banks and Bankers, 12 CFR 214	7-079.1 7-070 et seq.
Federal Reserve Act, sec. 13A	12 USC 348–352	Various provisions regarding authority of Federal Reserve Banks to discount and extend credit on agricultural paper.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-124–1-128 2-001 et seq.
Federal Reserve Act, sec. 14 (a)–(f)	12 USC 353–359	Authorizes open market operations: Federal Reserve Banks may purchase and sell instruments eligible for use as collateral for discount window transactions. Sets terms and conditions for open market operations. Also authorizes the Secretary of the Treasury to borrow and sell, repurchase, and return U.S. obligations from Reserve Banks in order to meet short-term obligations of the Treasury Department.	Federal Open Market Committee Rules, 12 CFR 270–272, 281	1-129–1-135 8-805 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 16, para. 13	12 USC 360	Reserve Banks must receive checks and drafts at par. Pricing of services for clearing negotiable instruments.	Reg J, Collection of Checks and Other Items by Federal Reserve Banks and Funds Transfers Through Fedwire, 12 CFR 210	1-152 9-775 et seq.
Federal Reserve Act, sec. 19(i)	12 USC 371a	Prohibits payment of interest on demand deposits by member banks and authorizes automatic transfer of funds from savings to checking.	Reg Q, Prohibition Against Payment of Interest on Demand Deposits, 12 CFR 217	1-175 2-380 et seq.
Federal Reserve Act, sec. 19(j)	12 USC 371b	Regulates the advertising of interest on time and savings deposits.	Reg DD, Truth in Savings, 12 CFR 230.8	1-176 6-1927 et seq.
Federal Reserve Act, sec. 23	12 USC 371b-2	Requires the Board to prescribe standards to limit the risks posed by exposure of insured depository institutions to other depository institutions.	Reg F, Limitations on Interbank Liabilities, 12 CFR 206	3-040 3-001
Federal Reserve Act, sec. 23A	12 USC 371c	Restrictions on extensions of credit and other covered transactions between affiliates. The Board has rulemaking and exemptive authority.		1-201 et seq. 3-1110 et seq.
Federal Reserve Act, sec. 23B	12 USC 371c-1	Restrictions on transactions with or for the benefit of affiliates. Requires transactions to be conducted on arm's-length terms. The Board has rulemaking and exemptive authority.		1-206.1 et seq.
Federal Reserve Act, sec. 24A	12 USC 371d	Limits investment by member banks in bank premises, and limits loans to or upon the security of the stock of any corporation owning bank premises.		1-216
Federal Reserve Act, sec. 13, para. 7	12 USC 372	Provisions regulating and setting limits on the acceptance of drafts and bills by member banks and U.S. branches and agencies of foreign banks.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-117 et seq. 2-001 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 19(e)	12 USC 374, 463	Member bank cannot act as agent for nonmember to obtain discount from a Reserve Bank. Also, limits the amount that a member bank can keep on deposit with a depository institution that is not authorized to have access to Federal Reserve advances under 12 USC 347b.	Reg A, Extensions of Credit by Federal Reserve Banks, 12 CFR 201	1-171 2-001 et seq.
Federal Reserve Act, sec. 19(d)	12 USC 374a	Member bank cannot act as agent for nonbank borrower in making loans on securities to investment securities dealers and brokers.		1-170
Federal Reserve Act, sec. 22(d)	12 USC 375	Provides that member banks may contract for, purchase from, or sell to any of their directors or to a firm of which a director is a member, any securities or other property, provided that the transaction is on terms not less favorable to the bank than those offered to others or when the transaction is approved by a majority of the directors who are not interested parties to the transaction. The Board may require disclosure of such transactions.		1-188 1-189
Federal Reserve Act, sec. 22(g)	12 USC 375a	Imposes lending limits and requirements for loans by member banks to their executive officers. Requires reports by executive officers for indebtedness at other banks.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215	3-1007 et seq. 3-960 et seq.
Federal Reserve Act, sec. 22(h)	12 USC 375b	Lending limits, prior board of directors' approval, and prohibition against preferential lending and overdrafts by member banks to their officers, directors, and principal shareholders and their related interests.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215	3-1011 et seq. 3-960 et seq.
Federal Reserve Act, sec. 22(e)	12 USC 376	Prohibits a member bank from paying to any director, officer, attorney, or employee a greater rate of interest on the deposits of such person than that paid to other depositors on similar deposits with such member bank.		1-190

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Banking Act of 1933	12 USC 378(a)(1)	Prohibits deposit taking by any person engaged in the business of issuing, underwriting, selling, or distributing securities.		1-311
Banking Act of 1933	12 USC 378(a)(2)	Prohibits any organization from engaging in the business of receiving deposits unless it is authorized to do so by law and is subject to examination.		1-311
Federal Reserve Act, sec. 15; and Act of July 16, 1943, sec. 3	12 USC 391, 392, 395	Authorizes Reserve Banks to act as fiscal agents and depositaries of the United States and other organizations.		1-138 1-139 1-280
Federal Reserve Act, sec. 16, paras.1–11	12 USC 411–421	Provides for the issuance, printing, custody, security, and destruction of Federal Reserve notes.		1-140 et seq.
Federal Reserve Act, sec. 16, para. 7	12 USC 417	Provides for custody and safekeeping of notes issued to and collateral deposited with reserve agent.		1-146
Federal Reserve Act, sec. 18	12 USC 441–448	Provides for the issuance, circulation, and redemption of certain bonds and notes of the United States.		1-158 et seq.
Federal Reserve Act, sec. 19(a)–(c), (f)–(h)	12 USC 461, 464–466	Authorizes Board to establish reserve requirements for all depository institutions, to define terms, and to require reporting with respect to the maintenance of reserves.	Reg D, Reserve Requirements for Depository Institutions, 12 CFR 204	1-167–1-169 1-172–1-174 2-122 et seq.
Federal Reserve Act, sec. 19(e)	12 USC 463	Limits deposits by member banks with a depository institution without access to Federal Reserve advances.		1-171
Federal Reserve Act, sec. 16, paras. 15–17	12 USC 467	Receipt of gold certificates and SDRs for credit with Federal Reserve System.		1-154 et seq.
Federal Reserve Act, sec. 21, para. 5	12 USC 483	Authorizes Federal Reserve Banks, with the approval of the Board, to provide for special examination of member banks.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.64	1-183 3-380

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 21, para. 6	12 USC 484	Limits visitorial powers other than as authorized by law.		1-184
Federal Reserve Act, sec. 21, para. 7	12 USC 485	Provisions relating to the examination of Federal Reserve Banks.		1-185
Federal Reserve Act, sec. 21, para. 9	12 USC 486	Permits Board to waive requirements that affiliates of state member banks either submit reports to state member banks or submit to examination.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.3(e)(2)	1-187 3-158
Revised Statutes sec. 5208	12 USC 501	Prohibits any officer, director, agent, or employee of a Federal Reserve Bank or a member bank from certifying a check drawn on the Federal Reserve Bank or member bank if the drawee has insufficient funds on deposit with the Federal Reserve Bank or member bank to cover the face amount of such check.		1-293
Federal Reserve Act, sec. 2, paras. 6 and 7	12 USC 501a	Provides that penalty for violation of Federal Reserve Act by national bank is forfeiture of charter in a suit brought by the Comptroller at the direction of Board.		1-009 1-010
Federal Reserve Act, sec. 2, para. 4	12 USC 502	Liability of shareholders of Federal Reserve Bank for obligations of the Reserve Bank.		1-007
Federal Reserve Act, sec. 22(f)	12 USC 503	Provides for personal liability of directors and officers of a member bank for a knowing violation of 12 USC 375, 375a, 375b, 376 (Federal Reserve Act, sections 22(d), (e), (g), and (h)) or regulations of the Board made under authority thereof and various provisions of title 18 (Criminal Code).		1-191
Federal Reserve Act, sec. 29	12 USC 504	Civil money penalty provision for violation by member bank of sections 22 and 23A of the Federal Reserve Act.	Rules of Practice for Hearings, 12 CFR 263, section 263.1(e) and subpart C	1-262 et seq. 8-044 8-086.3 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Reserve Act, sec. 19(*l*)(1)	12 USC 505	Civil money penalty provisions for violation by member bank of section 19 of the Federal Reserve Act.	Rules of Practice for Hearings, 12 CFR 263, section 263.1(e)(2) and subpart C	1-177 8-044 8-086.3 et seq.
Federal Reserve Act, sec. 3; and sec. 10, para. 9	12 USC 521–522	Provisions regarding Federal Reserve Bank branches and buildings.		1-018 et seq. 1-085
Federal Reserve Act, sec. 7(c)	12 USC 531	Exempts Federal Reserve Banks from federal, state, and local taxes except on real property.		1-050
Federal Reserve Act, sec. 25	12 USC 601–604a	Authorizes national banks to establish foreign branches; to invest in foreign banks; and to invest in corporations engaged in international banking. These provisions apply to state member banks through 12 USC 335 and 321 (Federal Reserve Act, sec. 9, para. 20 and para. 3).	Reg K, International Banking Operations, subpart A, 12 CFR 211	1-217 et seq. 3-587 et seq.
Federal Reserve Act, sec. 25A (Edge Act)	12 USC 611–631	Authorizes member banks and foreign banks to establish corporations to engage in international banking and finance (Edge Act corporations); such corporations may conduct international banking operations through offices in the United States and overseas and may invest in foreign organizations. Edge corporations are subject to reserve requirements of Regulation D (12 CFR 204), limitations on interest on deposits of Regulation Q (12 CFR 217), and the Board's margin limitations.	Reg K, International Banking Operations, 12 CFR 211, subpart A	1-227 et seq. 3-587 et seq.
Federal Reserve Act, sec. 25B	12 USC 632	Governs disposition of property of a foreign state held by a Federal Reserve Bank; gives federal courts original jurisdiction over all civil suits involving Federal Reserve Banks or corporations engaged in international banking.	Reg N, Relations with Foreign Banks and Bankers, 12 CFR 214	1-252 et seq. 7-070 et seq.
Home Owners' Loan Act of 1933	12 USC 1470	Authorizes Board to regulate investment by state member banks in state housing corporations.		1-297.1 1-297.2

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
National Housing Act of 1934, sec. 303(d)	12 USC 1718(d)	Authorizes insured banks to invest in the stock of the Federal National Mortgage Association.		1-298
National Housing Act of 1934	12 USC 1735f-5	Prohibits discrimination based on sex in the making of a federally related mortgage or loan. The combined income of spouses shall be considered in determining whether or not to extend mortgage credit.		
Federal Deposit Insurance Act, sec. 4(b)	12 USC 1814(b)	Requires state member banks that accept deposits to obtain insurance.		1-337
Federal Deposit Insurance Act, sec. 7(a)(3)	12 USC 1817(a)(3)	Requires quarterly reports of condition for insured banks to ensure safety and soundness.		1-341
Change in Bank Control Act, (Federal Deposit Insurance Act sec. 7(j))	12 USC 1817(j)	Requires prior notice to the appropriate agency for a proposed change in control of an insured bank or bank holding company. Establishes disapproval criteria and provides for civil money penalties for violations. Requires reports on loans secured by 25% or more of the stock of another insured bank.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart E	1-344 et seq. 4-051.8 et seq.
Federal Deposit Insurance Act, sec. 7(k)	12 USC 1817(k)	Reporting and public disclosure by insured banks of information concerning extensions of credit by the bank to its officers and principal shareholders and their related interests.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1025 3-987 et seq.
Federal Deposit Insurance Act, sec. 8(b)–(n)	12 USC 1818(b)–(n)	Cease-and-desist authority over state member banks, bank holding companies, and their nonbank subsidiaries, Edge and agreement corporations, and foreign banks with state agencies or uninsured branches in the United States, and officers, directors, employees, agents, or others for violations of law or unsafe or unsound practices.	Rules of Practice for Hearings, 12 CFR 263	1-356 et seq. 8-043 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Deposit Insurance Act, sec. 8(e)	12 USC 1818(e)	Authorizes suspension, removal, or prohibition from participation of parties affiliated with state member banks, bank holding companies, and other institutions under the Board's jurisdiction for violations of law or unsafe or unsound practices.	Rules of Practice for Hearings, 12 CFR 263, subpart A	1-363 et seq. 8-043 et seq.
Federal Deposit Insurance Act, sec. 8(g)	12 USC 1818(g)	Authorizes suspension, removal, or prohibition from participation of parties affiliated with a state member bank who is charged with a felony.	Rules of Practice for Hearings, 12 CFR 263, subpart D	1-369 et seq. 8-086.9 et seq.
Federal Deposit Insurance Act, sec. 8(i)	12 USC 1818(i)	Provides for civil money penalty of up to $5,000 per day for violation of an order issued under 12 USC 1818(b), (c), (e), (g), or (s). Also provides for enforcement of an order.	Rules of Practice for Hearings, 12 CFR 263, subparts A and C	1-374 et seq. 8-043 et seq. 8-086.3 et seq.
Federal Deposit Insurance Act, sec. 8(r)	12 USC 1818(r)	Provides for removal of an officer, director, employee, or agent of a foreign bank for a violation of law or unsafe or unsound practice in the United States.	Rules of Practice for Hearings, 12 CFR 263, subpart A	1-383.1 et seq. 8-043 et seq.
Federal Deposit Insurance Act, sec. 10(c) and (d)	12 USC 1820(c) and (d)	Authorizes taking of testimony under oath and the issuance of subpoena in connection with bank examination.		1-385 1-385.01
Federal Deposit Insurance Act, sec. 13(f); Bank Holding Company Act of 1956, sec. 3(d)	12 USC 1823(f) and 1842(d)	Permits a bank holding company to acquire a failing bank in a state outside its principal state of banking operations.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.13(c)	1-385.2 et seq. 4-069 4-024
Bank Merger Act of 1966	12 USC 1828(c)	Requires prior written agency approval for any insured bank merger or consolidation or the acquisition of assets by an insured bank. Establishes uniform approval standards and notice requirements.		1-386 et seq.
Federal Deposit Insurance Act, sec. 18(i)	12 USC 1828(i)	Requires prior written approval of the appropriate agencies for an insured bank to convert to an insured state bank if the bank will reduce or retire stock as part of the conversion.		1-396 1-397

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Federal Deposit Insurance Act, sec. 19	12 USC 1829	Prohibition against service, without FDIC approval, as director, officer, or employee of an insured bank upon conviction for crime involving dishonesty or breach of trust.		1-398.5 et seq.
Bank Secrecy Act of 1970; Currency and Foreign Transactions Reporting Act of 1978	12 USC 1829b 12 USC 1951–1959 31 USC 5311–5330	Requires insured banks and uninsured banks to maintain records on identities of account holders; requires reproductions or microfilm of checks and other instruments drawn on or presented to it, and other records for use in criminal, tax, or regulatory investigations. Requires the maintenance of appropriate types of records and the making of appropriate reports by businesses in the United States when records or reports have a high degree of usefulness in criminal, tax, or regulatory investigations or proceedings.	Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 CFR 1010 (Treasury reg)	3-1700 et seq.
Federal Deposit Insurance Act, sec. 38	12 USC 1831o	Prompt corrective action—defines the capital measures and capital levels used for determining supervisory actions.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.40	1-400.4 et seq. 3-325 3-326
Federal Deposit Insurace Act, sec. 39	12 USC 1831p-1	Safety-and-soundness standards. Requires banking agency to prescribe standards relating to banking operations, asset quality, earnings, and executive compensation.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208, app. D-1	1-401 et seq. 3-1579.3
Consumer Checking Account Equity Act of 1980; Federal Reserve Act, sec. 19(i)	12 USC 1832, 371a	Authorizes depository institutions to offer NOW accounts and automatic transfers from savings to checking.		1-175
Bank Holding Company Act of 1956	12 USC 1841 et seq.	Governs acquisition of bank stock by companies and provides generally for the separation of banking and commerce by restricting the activities in which bank affiliates may engage.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225	4-001 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Holding Company Act of 1956, sec. 2(h)(2); International Banking Act of 1978	12 USC 1841(h)(2) 12 USC 3101 et seq.	Permits foreign banks that are subject to the International Banking Act to hold shares of a foreign nonbanking company that engages in business in the United States, provided that the U.S. activities are in the same line of business as the foreign activities of the foreign nonbank company. Exemption does not extend to securities activities or banking or financial operations.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(h); Reg K, International Banking Operations, 12 CFR 211, subpart B	4-064 4-037 1-562 et seq. 3-671 3-630 et seq.
Bank Holding Company Act of 1956, sec. 3	12 USC 1842	Requires prior Board approval to become a bank holding company; to acquire more than 5% of another bank; to merge or consolidate bank holding companies. Requires notice of filing of applications to other regulators. Prohibits interstate acquisitions except in the case of failing institutions under 12 USC 1823(f) or where state law permits.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart B	4-066 et seq. 4-018 et seq.
Bank Holding Company Act of 1956, sec. 4	12 USC 1843	Generally prohibits acquisition of more than 5% of the shares of a nonbank company. Exceptions include shares of kind eligible for investment by national banks; and where Board finds the activities to be so closely related to banking as to be a proper incident thereto. The Board has delineated over 20 activities as closely related to banking.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subpart B	4-071 et seq. 4-018 et seq.
Bank Holding Company Act of 1956, sec. 4(a)(2)	12 USC 1843(a)(2)	Provides grandfather rights for nonbanking activities commenced before June 30, 1968.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(g)	4-071 4-072 4-037
Bank Holding Company Act of 1956, sec. 4(c)(9)	12 USC 1843(c)(9)	Permits Board to grant further nonbanking exemptions to foreign banks if the exemptions are not substantially at variance with the purposes of the act and are in the public interest.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.22(h); Reg K, International Banking Operations, 12 CFR 211, subpart B	4-078 4-037 et seq. 3-630 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Holding Company Act of 1956 sec. 4(c)(13)	12 USC 1843(c) (13)	Permits bank holding companies to acquire foreign companies that do no business in the United States except as an incident to their foreign business.	Reg K, International Banking Operations, 12 CFR 211.5	4-080 3-609 et seq.
Bank Holding Company Act of 1956, sec. 4(c)(14)	12 USC 1843(c) (14)	Permits bank holding companies to invest in export trading companies, i.e., companies exclusively engaged in matters relating to international trade and principally engaged in exporting.	Reg K, International Banking Operations, 12 CFR 211, subpart C	4-080.1 3-649 et seq.
General authority to consider safety and soundness		Prohibits redemption of bank holding company equity securities under certain circumstances without prior notice to Board in order to prevent unsafe or unsound reductions of capital.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.4(b)	4-013 et seq.
Bank Holding Company Act sec. 4(k)–(o)	12 USC 1843(k)–(o)	Permits bank holding companies and foreign banks that qualify as financial holding companies to engage in securities, insurance, and other activities that are financial in nature or incidental to a financial activity and to make merchant banking investments.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225, subparts I and J	4-082.7 et seq. 4-056 et seq.
Bank Holding Company Act of 1956, sec. 5(a)–(d), (f)	12 USC 1844	Requires bank holding companies to register with Board and authorizes Board to issue regulations to carry out the purposes of the act, to require reports and conduct examinations of bank holding companies and their subsidiaries, and to take depositions and subpoena documents.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225; Rules of Practice for Hearings, 12 CFR 263	4-083–4-085 4-088 4-001 et seq. 8-043 et seq.
Bank Holding Company Act of 1956, sec. 5(e)	12 USC 1844(e)	Authorizes Board to require divestiture of nonbank subsidiaries or termination of nonbank activity if the Board determines that the subsidiary or activity constitutes a serious risk to the financial safety and soundness or stability of bank holding company.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.4(a)	4-086 4-087 4-012
Bank Holding Company Act Amendments of 1970, sec. 106(b)	12 USC 1972	Prohibition against tie-in arrangements by banks. The Board has rulemaking and exemptive authority.	Reg Y, Bank Holding Companies and Change in Bank Control, 12 CFR 225.7	4-147 et seq. 4-017.1 4-017.2

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)	12 USC 1972(2)	Prohibits preferential extensions of credit by insured banks based on correspondent account relationships.	Reg O, Loans to Executive Officers, Directors and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1018 et seq. 3-987 et seq.
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)(G)(i)	12 USC 1972(2)(G)(i)	Reporting and public disclosure requirements for executive officers and principal shareholders of insured banks with respect to extensions of credit from correspondent banks.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1023 3-987 et seq.
Bank Holding Company Act Amendments of 1970, sec. 106(b)(2)(G)(ii)	12 USC 1972(2)(G)(ii)	Reporting and public disclosure requirements for insured banks regarding extensions of credit by correspondent banks to the reporting bank's officers and principal shareholders.	Reg O, Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks, 12 CFR 215, subpart B	3-1024 3-987 et seq.
Bank Service Company Act, sec. 1–7	12 USC 1861–1867	Permits insured banks to invest in a corporation that provides services for depository institutions; and, with the prior approval of the agency, in a bank service company that provides services to others that are authorized for its bank parent(s) only at locations where its bank parent(s) may perform such services.		1-324 et seq.
Bank Service Company Act, sec. 5	12 USC 1865	Requires prior Board approval for a member bank to invest in a bank service company that performs services permissible for bank holding companies under section 4(c)(8) of the BHC Act and at any geographic location other than where its parent could perform the service.		1-327.1

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Bank Protection Act of 1968, sec. 2–5	12 USC 1881–1884	Requires establishment of standards for installation, maintenance, and operation of bank security devices and procedures. Requires annual reports of compliance and appointment of a security officer.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.61	1-472 et seq. 3-371 et seq.
Credit Control Act	12 USC 1901–1909	Permits Board, upon authorization by the president, to regulate and control all extensions of credit, and to require reports regarding any extensions of credit. Authorizes imposition of civil money penalties on any person who violates the regulations or fails to report as required. (Expired June 30, 1982.)		1-535 et seq.
Real Estate Settlement Procedures Act	12 USC 2601–2617	Requires disclosure of all costs associated with purchases of real estate and prohibits payments of kickbacks and unearned fees in any transaction concerning a federally related mortgage.	Real Estate Settlement Procedures, 24 CFR 3500 (HUD reg)	6-1350 et seq. 6-1370 et seq.
Home Mortgage Disclosure Act	12 USC 2801–2811	Requires reports and public disclosure of the number and amount of mortgage loans made by depository institutions within a geographic area by census tract.	Reg C, Home Mortgage Disclosure, 12 CFR 203	6-228 et seq. 6-200 et seq.
Community Reinvestment Act	12 USC 2901–2905	Requires federal financial supervisory agencies to examine depository institutions to determine whether such institutions are meeting the credit needs of their communities; and requires such agencies to consider the records of such institutions in meeting community credit needs in acting on applications by such institutions for additional deposit facilities.	Reg BB, Community Reinvestment, 12 CFR 228	6-1247 et seq. 6-1220 et seq.
International Banking Act of 1978, sec. 1	12 USC 3101	Foreign banks required to designate a home office if they do not have deposit-taking offices. The Riegle-Neal Interstate Banking Act of 1994 removed geographic restrictions on interstate banking by foreign banks.	Reg K, International Banking Operations, 12 CFR 211.22	1-562 et seq. 3-633

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
International Banking Act of 1978, sec. 5	12 USC 3103	Restricts the U.S. expansion of a foreign bank's deposit-taking capabilities across state lines; provides for establishment of limited branches that accept only those deposits permissible for an Edge corporation; and imposes prohibition contained in section 3(d) of the Bank Holding Company Act on acquisition of bank assets or shares outside the foreign bank's home state.	Reg K, International Banking Operations, 12 CFR 211, subpart B	1-565 et seq. 3-630 et seq.
International Banking Act of 1978, sec. 7(a)	12 USC 3105(a)	Subjects U.S. branches and agencies of foreign banks to reserve requirements and prohibition against payment of interest on demand deposits.	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204; Reg Q, Prohibition Against Payment of Interest on Demand Deposits, 12 CFR 217	1-567 2-122 et seq. 2-380 et seq.
International Banking Act of 1978, sec. 7(c); Federal Reserve Act, sec. 13, para. 14	12 USC 3105(c) 12 USC 347d	Gives Board authority to examine each U.S. branch, agency, or commercial lending company of a foreign bank. Requires each branch or agency to submit quarterly Reports of Condition. Subjects branches and agencies to prohibitions on underwriting and dealing in securities.		1-569 1-123.1
International Banking Act of 1978, sec. 8	12 USC 3106	Subjects foreign bank with a U.S. branch, agency, commercial lending company, or subsidiary bank to the Bank Holding Company Act; grandfathers certain activities and investments of foreign banks; prohibits tie-in arrangements under section 106(b) of the Bank Holding Company Act Amendments of 1970 (12 USC 1972).	Reg K, International Banking Operations, 12 CFR 211, subpart B	1-571 et seq. 3-630 et seq.
		Foreign banks permitted to establish U.S. representative offices without filing a formal application.	Reg K, International Banking Operations, 12 CFR 211.24	3-648.1

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
		Criteria for "well-managed."	Reg K, International Banking Operations, 12 CFR 211.5	3-609 et seq.
		Criteria for evaluating the U.S. operations of foreign banks that the Board determines are not subject to comprehensive consolidated supervision or regulation.	Reg K, International Banking Operations, 12 CFR 211.30	3-648.7 et seq.
International Banking Act of 1978, sec. 9(b)	12 USC 3106a	Prohibits discrimination by U.S. offices of foreign banks and requires disapproval of applications by such foreign banks if banks do not agree to comply with antidiscrimination laws.		1-573.1
Depository Institutions Management Interlocks Act	12 USC 3201–3208	Prohibits management official interlocks between two depository organizations if they are not affiliated and are either very large or located in the same local area.	Reg L, Management Official Interlocks, 12 CFR 212	3-801 et seq. 3-775 et seq.
Federal Financial Institutions Examination Council Act	12 USC 3301–3308	Establishes a council to prescribe uniform principles, standards, and report forms for examination of financial institutions and to promote uniformity in other supervisory matters.	12 CFR 1101 (FFIEC reg)	
Right to Financial Privacy Act	12 USC 3401–3422	Establishes standards under which a federal government agency may obtain, and a financial institution may provide, information contained in financial records of a customer of the financial institution. Provides for cost reimbursement to institution for furnishing records of customers.	Reg S, Reimbursement to Financial Institutions for Assembling or Providing Financial Records, 12 CFR 219	6-1750 et seq. 3-1200 et seq.
Garn–St Germain Depository Institutions Act of 1982, sec. 204	12 USC 3503	Establishes a deposit account directly equivalent to a money market mutual fund and exempts such account from transaction account reserves, section 19(b) of the Federal Reserve Act (12 USC 461).	Reg D, Reserve Requirements of Depository Institutions, 12 CFR 204.2(d)(2)	2-138.1
Truth in Savings Act	12 USC 4301 et seq.	Requires clear and uniform disclosures about deposit accounts.	Reg DD, Truth in Savings, 12 CFR 230	6-1900 et seq.

Statute	U.S. Code Citation	Description	FRB Regulation	FRRS Locator Number
Federal Deposit Insurance Corporation Improvement Act, sec. 401–407	12 USC 4401–4407	Validates netting contracts among financial institutions and expands definition of "financial institution."	Payments System Risk Policy; Reg EE, Netting Eligibility for Financial Institutions, 12 CFR 231	9-1500 et seq. 9-1000 et seq. 9-1475 et seq.
Clayton Antitrust Act, sec. 7 and 8	15 USC 18, 19	Prohibits mergers, acquisitions, and similar transactions between banks that substantially lessens competition. Prohibits certain interlocking bank directorates.		1-404 et seq.
Robinson-Patman Anti-Discrimination Act, sec. 11	15 USC 21	Authorizes Board to take enforcement action against banks for discrimination in price, services, and facilities.		1-407 et seq.
Federal Trade Commission Act, sec. 18(f)	15 USC 57a(f)	Authorizes Board to adopt rules prohibiting unfair or deceptive acts or practices by banks and to take regulatory action to prohibit those acts or practices on its own motion and to mirror comparable rules adopted by Federal Trade Commission.	Reg AA, Unfair or Deceptive Acts or Practices, 12 CFR 227	6-1203 6-1204 6-1200 et seq.
Securities Exchange Act of 1934, sec. 17A	15 USC 78q-1	Provides for the registration of state member banks acting as transfer agents and municipal securities dealers; establishes procedure for registration and withdrawal of transfer agents and municipal securities dealers and sets forth enforcement authority over clearing agents, transfer agents, and municipal securities dealers.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208, subpart C	5-173 et seq. 3-250 et seq.
Securities Exchange Act of 1934	15 USC 78b, 78c, 78i, 78j, 78*l*, 78p, 78r, 78t, 78u, 78w, 78x, 78aa, 78bb, 78dd, 78ff	Regulates transactions in bank securities to prevent unfair or manipulative practices, requires reports by publicly held banks, including securities registration statements, proxy statements, and periodic financial statements and reports by officers and directors regarding their shareholdings.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.36	5-001 et seq. 3-285 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Securities Exchange Act of 1934, sec. 7 and 8	15 USC 78g, 78h	Authorizes Board to regulate amount of credit that may be extended to finance securities transactions; makes it unlawful for brokers, dealers, members of exchanges, or other persons to extend credit for the purpose of purchasing or carrying securities without complying with rules issued by the Board. Also makes it unlawful for any person to obtain an extension of credit in the United States or for a U.S. person or a foreign person controlled by or acting on behalf of a U.S. person to purchase various types of securities without complying with rules issued by the Board. Makes it unlawful for any registered broker, dealer, or member of a national securities exchange to (1) borrow on any registered security except from specified classes of banks, (2) arrange for the hypothecation of customer securities in contravention of Board rules, and (3) lend or arrange for the lending of a customer's securities in contravention of Board rules.	Reg T, Credit by Brokers and Dealers, 12 CFR 220; Reg U, Credit by Banks or Persons Other Than Brokers or Dealers for the Purpose of Purchasing or Carrying Margin Stocks, 12 CFR 221; Reg X, Borrowers of Securities Credit, 12 CFR 224	5-049 et seq. 5-392 et seq. 5-745 et seq. 5-970 et seq.
Securities Exchange Act of 1934, sec. 30A and 30B	15 USC 78dd-1, 78dd-2	Prohibits an issuer of securities registered under the Securities Exchange Act from giving anything of value to a foreign official to influence any act or decision of said official. Banking agencies have determined that such actions are considered unsafe and unsound practices.		5-248 et seq.
Public Utility Holding Company Act	15 USC 79q	Prohibits director and officer interlocks between a public utility holding company and a bank without SEC approval.		
Investment Company Act of 1940, sec. 10(c)	15 USC 80a-10	Prohibits a registered investment company from having a majority of its board of directors consist of officers, directors, or employees of any one bank.		5-262
Small Business Act, sec. 6	15 USC 635(a)	Authorizes Federal Reserve Banks to act as fiscal agents for the Small Business Administration.		1-277

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Small Business Investment Act, sec. 302	15 USC 682	Authorizes member banks to invest in Small Business Investment Companies up to 5% of bank's capital and surplus.		1-299
Truth in Lending Act	15 USC 1601–1646	Requires creditors to disclose to consumers the cost and terms of credit; gives consumers the right to cancel certain credit transactions; regulates credit card issuance and liability; prescribes certain requirements for advertising credit.	Reg Z, Truth in Lending, 12 CFR 226 (covers all creditors)	6-1030 et seq. 6-600 et seq.
Fair Credit Billing Act	15 USC 1666–1666j	Provides for fair and timely resolution of credit billing disputes; regulates certain credit card practices.	Reg Z, Truth in Lending, 12 CFR 226 (covers all creditors)	6-1109 et seq. 6-600 et seq.
Consumer Leasing Act	15 USC 1667–1667e	Requires accurate disclosure of consumer leasing terms; limits lessee liability; prescribes certain requirements for advertising consumer leases.	Reg M, Consumer Leasing, 12 CFR 213 (covers all lessors)	6-550 et seq. 6-500 et seq.
Fair Credit Reporting Act	15 USC 1681–1681t	Protects consumers against inaccurate or misleading information in credit files maintained by credit bureaus; requires these bureaus to allow credit applicants to correct erroneous reports.		6-1550 et seq.
Equal Credit Opportunity Act	15 USC 1691–1691f	Prohibits credit discrimination on the basis of race, color, religion, national origin, sex, marital status, or age or because of receipt of public assistance or exercise of rights under the consumer Credit Protection Act; requires creditors to notify applicants of action taken on the application.	Reg B, Equal Credit Opportunity, 12 CFR 202 (covers all creditors)	6-091 et seq. 6-001 et seq.
Equal Credit Opportunity Act, sec. 703(b)	15 USC 1691b	Authorizes Board to establish a Consumer Advisory Council to advise and consult with the Board on the Consumer Credit Protection Act and other consumer-related matters.	Rules of Organization and Procedure of the Consumer Advisory Council, 12 CFR 267	6-100 6-2500 et seq.
Fair Debt Collection Practices Act	15 USC 1692	Prohibits the use of abusive, deceptive, and unfair debt collection practices by third-party debt collectors.		6-1675 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Electronic Fund Transfer Act	15 USC 1693–1693r	Prescribes disclosure and documentation requirements for institutions involved in electronic funds transfers; requires prompt resolution of errors on electronic transfer accounts; limits customer liability for unauthorized use of EFT card.	Reg E, Electronic Fund Transfers, 12 CFR 205	6-359 et seq. 6-300 et seq.
Emergency Loan Guarantee Act	15 USC 1841–1852	Creates the Emergency Loan Guarantee Board (composed of the secretary of the Treasury, chairman of the Federal Reserve Board, and chairman of the SEC) to guarantee loans for borrowers whose failure would adversely affect the economy. (Authority to enter into a guarantee ended 12/31/73.)		1-548 et seq.
Emergency Loan Guarantee Act, sec. 10	15 USC 1849	Authorizes Federal Reserve Banks to act as fiscal agents for the Loan Guarantee Board.		1-558
Criminal Code sec. 208	18 USC 208	Establishes standards of conduct for Reserve Bank directors in the exercise of their duties.	Reserve Bank Directors—Actions and Responsibilities, 12 CFR 264a	8-168 et seq.
Act of June 25, 1948	18 USC 212–215, 655, and 1906	Prohibits the offering of or acceptance by a bank examiner of a loan or gratuity, as well as theft or disclosure of confidential banking data by a bank examiner. Also prohibits bank officers, directors, employees, agents, or attorneys from receiving payment for procuring or attempting to procure a loan or extension of a loan for a third party.		1-451 et seq. 1-456 1-465
Bank Bribery Act	18 USC 215	Proscribes corrupt activity within financial institutions. Federal Reserve guidelines issued by the Board on October 21, 1987 (SR-87-36) inform state member banks and bank holding companies to develop codes or policies to alert bank or bank holding company officials about the bank bribery statute, as well as to establish and enforce standards relating to acceptable business practices.		1-454 3-1504

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Various statutes	22 USC 282d, 283d, 284d, 285d, 290g-5, 290i-5	Authorizes Reserve Banks to act as depositories and/or fiscal agents for various agencies, such as the International Finance Corporation, Inter-American Development Bank, International Development Association, Asian Development Bank, African Development Fund, and African Development Bank.		9-839 et seq.
Bretton Woods Agreements Act, sec. 4	22 USC 286b	Authorizes the chairman of the Board and others to establish the National Advisory Council on International Monetary and Financial Problems.		1-477– 1-480
Bretton Woods Agreements Act, sec. 6	22 USC 286d	Authorizes Reserve Banks to act as fiscal agents or as a depository for the IMF and the International Bank for Reconstruction and Development.		9-836
Bretton Woods Agreements Act, sec. 8	22 USC 286f and Exec. Order 10033	Authorizes Board to require persons, by subpoena or otherwise, to provide information at the request of the president.		1-484 1-485
Special Drawing Rights Act of 1968	22 USC 286p	Authorizes issuance of special drawing rights to Reserve Bank.		1-290
Internal Revenue Code	26 USC 5703, 6302	Authorizes Reserve Banks to receive taxes imposed on tobacco products, any other tax under Internal Revenue laws, or state individual income taxes.		1-269
Bank Secrecy Act of 1970; Currency and Foreign Transactions Reporting Act of 1978	31 USC 5311– 5322	Requires persons and financial institutions involved in the transmission of funds exceeding specified amounts to or from the United States to file reports with the secretary of the Treasury in order to further enforcement of criminal, tax, or other investigatory proceedings.	Financial Recordkeeping and Reporting of Currency and Foreign Transactions, 31 CFR 1010 (Treasury reg)	3-1700 et seq. 3-1760 et seq.
Fair Housing Act	42 USC 3601– 3619	Prohibits discrimination on the basis of race, color, religion, sex, or national origin in housing-related transactions; requires agencies to administer housing-related activities and programs in a way that affirmatively promotes the purposes of the act.		6-1450 et seq.

Statute	*U.S. Code Citation*	*Description*	*FRB Regulation*	*FRRS Locator Number*
Flood Disaster Protection Act; National Flood Insurance Act	42 USC 4003, 4012a, 4104a, 4106, 4128	Prohibits federally regulated lending institutions from making any loan secured by improved real estate or a mobile home located in designated flood hazard areas unless the property is covered by flood insurance. Also prohibits lending by such institutions in designated flood hazard areas without prior notice to purchasers of such property.	Reg H, Membership of State Banking Institutions in the Federal Reserve System, 12 CFR 208.25	1-331 et seq. 3-213 et seq.
Defense Production Act of 1950	50 App. USC 2091, 2152 et seq. Exec. Order 12919	Authorizes Board to establish interest rates, fees, and other charges on federally guaranteed loans for defense production under the act or executive order. Authorizes Federal Reserve Banks to act as fiscal agents for any guaranteeing agency, under the supervision of the Board.		

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