

# Risk Management

## Introduction

Effective date July 1997

## Section 3000.1

Taking and managing risks are fundamental to the business of banking. The U.S. banking supervisory agencies place significant emphasis on the adequacy of an institution's management of risk, including the establishment of a management structure that adequately identifies, measures, monitors, and controls the risks involved in its various products and lines of business. In a branch, which is typically removed from its head office by location and time zone, an effective risk management system is critical not only to manage the scope of its activities but to achieve comprehensive, ongoing oversight by branch and head office management. In the examination process, examiners will therefore determine the extent to which risk management techniques are adequate (1) to control risk exposures that result from the branch's activities and (2) to ensure adequate oversight by branch and head office management and thereby promote a safe and sound banking environment.

Principles of sound management should apply to the entire spectrum of risks facing a branch including, but not limited to, the following:

- *Credit risk* which arises from the potential that a borrower or counterparty will fail to perform on an obligation.
- *Country/transfer risk* which encompasses the entire spectrum of risks arising from the economic, social and political environments of a foreign country which may have potential consequences for foreigners' debt and equity investments in that country. More specifically, transfer risk focuses on a borrower's capacity to obtain the foreign exchange required to service its cross-border debt.
- *Market risk* which is the risk to a financial institution resulting from adverse movements in market rates or prices, such as interest rates, foreign exchange rates, or equity prices.
- *Liquidity risk* which is the potential that a branch 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 ("market liquidity risk").

- *Operational risk*<sup>1</sup> which 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* which arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of the branch.

### ELEMENTS OF RISK MANAGEMENT

When rating the quality of risk management at branches, examiners should place primary consideration on findings relating to the following elements of a sound risk management system:

- active senior management oversight at the head office, regional management office (if applicable) and local branch levels;
- adequate policies, procedures, and limits; and
- a strong management information system for measuring, monitoring and reporting risks.

Each of these elements is described further below, along with a list of considerations relevant to assessing the adequacy of 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 not as a checklist of requirements for each branch.

Adequate risk management programs can vary considerably in sophistication, depending on the size and complexity of the FBO and its branch network and the level of risk that it accepts. Examiners need to ensure that senior managers at the head office and/or at the regional management office are provided with the information they need to monitor and direct day-to-day activities of the branch.

The risk management processes of branches would typically contain detailed guidelines that

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1. While operational and legal risks are identified as part of the branch's overall risk assessment process, the effectiveness of the branch's operational controls are included in the "O" component of the ROCA rating system assessment. Further, when legal risks potentially result in violations of law or regulation, the "C" component would also be impacted.

set specific prudential limits on the principal types of risks relevant to the FBO's activities worldwide. Reporting systems 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 senior management at the head office and, where applicable, the regional management office.

The risk management systems will naturally require independent monitoring and testing in addition to review by internal or 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 FBOs 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.

## ACTIVE HEAD OFFICE SENIOR MANAGEMENT OVERSIGHT

As part of its responsibility to provide a comprehensive system of oversight for the branch, the head office has a role in developing and approving a risk management system for the branch. Senior management at the head office, regional management office and local branch levels are responsible for implementing strategies in a manner that limits risks associated with each strategy, and that ensures compliance with laws and regulations on both a long-term and day-to-day basis. Accordingly, branch management should be fully involved in the activities of the branch 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. Management is also responsible for establishing and communicating a strong awareness of and need for effective internal controls and high ethical standards.

In assessing the quality of the oversight by head office, regional and branch management, examiners should consider whether the branch follows policies and practices such as the following:

- Management has identified and clearly understands the types of risks inherent in the activities of the branch and makes appropriate efforts to remain informed about these risks as

financial markets, risk management practices, and the branch's activities evolve. Management periodically reviews risk exposure limits to ensure they are appropriate considering changing circumstances.

- Management has reviewed and approved appropriate policies to limit risks inherent in all significant activities of the branch, including lending, investing, trading, private banking, and trust.
- Management is sufficiently familiar with and is using adequate recordkeeping and reporting systems to measure and monitor the major sources of risk to the branch.
- Management ensures that the branch's areas of activities are managed and staffed by personnel with knowledge and experience consistent with the nature and scope of these activities.
- Management ensures that the depth of staff resources is sufficient to operate and manage the activities of the branch and that branch employees have the necessary integrity, ethical values, and competence.
- Management at all levels provides adequate supervision of the day-to-day activities of all employees, including senior officers.
- Management is able to respond to risks that may arise from changes in the competitive environment or from innovations in markets in which the branch is active.
- Management identifies and reviews all risks associated with new activities or products and ensures that the branch infrastructure and internal controls in place are adequate to manage related risks prior to commencing new activities or offering new products.

## ADEQUATE POLICIES, PROCEDURES AND LIMITS

Head office management should tailor risk management policies and procedures to the types of risks that arise from the activities the branch conducts. Once the risks are properly identified, the branch's policies and procedures provide detailed guidance for the day-to-day implementation of broad business strategies, and generally include limits designed to shield the branch from excessive or imprudent risks. While all branches should have policies and procedures that address significant activities and risks, the coverage and level of detail in these policies and

procedures will vary among branches. A smaller, less complex branch that has effective management that is actively 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 branch, where senior management must rely on widely-dispersed staff to implement strategies in an extended range of potentially complex businesses, far more detailed policies and related procedures would generally be expected. In either case, management is expected to ensure that policies and procedures address the material areas of risk to the FBO and the branch and that they are modified when necessary to respond to significant changes in the branch's activities or business conditions.

In evaluating the adequacy of a branch's policies, procedures and limits, examiners should consider whether:

- The branch's policies, procedures and limits provide for adequate identification, measurement, monitoring and control of the risks posed by lending, investing, trading, private banking, trust and other significant activities.
- The branch's policies, procedures and limits are consistent with the experience level, stated goals and objectives, and overall financial strength of the organization.
- Policies clearly delineate accountability and lines of authority across the branch's activities.

## EFFECTIVE RISK MONITORING AND MANAGEMENT INFORMATION SYSTEMS

Effective risk monitoring requires branches to identify and measure all risk exposures. Consequently, risk monitoring activities must be supported by information systems that provide senior managers at the head office, regional office, and branch 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 to engage in the day-to-day management of the branch's activities.

The sophistication of the risk monitoring and management information systems should be consistent with the complexity and diversity of the branch's operations. Accordingly, smaller and less complicated branches may require only a limited set of management 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 complex branches, 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. Branches of all sizes are expected to have risk monitoring and management information systems in place that provide senior management with a clear understanding of the branch's positions and risk exposures.

In assessing the adequacy of the measurement and monitoring of risk as well as management reports and information systems at a branch, examiners should consider whether:

- The branch's risk monitoring practices and reports address all risks.
- Key assumptions, data sources, and procedures used to measure and monitor risk are appropriate, adequately documented and periodically tested.
- Reports and other forms of communication are consistent with the activities of the branch, are structured to monitor exposures and compliance with established limits, goals and objectives, and, as appropriate, compare expected to actual performance.
- Reports to head office are accurate and timely and contain sufficient information for senior management to identify any adverse trends and to evaluate the level of risk assumed by the branch.

### CREDIT RISK

This section is devoted to credit risks associated with direct lending arrangements. The comprehensiveness of a credit risk management system will depend upon the sophistication and types of credit-related activities being conducted by the branch. In some circumstances, a branch may have no independent lending authority and may simply serve as a booking office for loans approved by the head office. A more active branch may, however, have an independent credit review department and established lending authorities. Therefore, credit policies, procedures, and documentation may vary significantly.

This section will assist the examiner in performing two separate, but interrelated, procedures:

- The evaluation of the depth and scope of formalized policies and procedures used by the branch to manage and control its credit risks.
- An overview of the performance of the branch's entire lending operations by evaluating the results of all lending departments.

### Branch Credit Administration Policies

As part of the analysis of a branch's loan portfolio, examiners review credit policies, credit administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation is essential to the institution's management of the lending function.

The policies and procedures governing a branch's lending activities must be clearly communicated to management and lending staff. These policies and procedures must define prudent underwriting standards, credit risk controls, prudent internal limits, and an effective credit review and risk identification process. The complexity and scope of these policies and procedures should be appropriate to the size and nature of the branch's activities, and should be consistent with prudent banking practices and applicable federal and state laws and regulations.

The establishment of a written lending policy provides the foundation for sound loan portfolio

management. Throughout this manual there is considerable emphasis on the establishment of formal written policies to guide and manage the scope of the branch's activities within acceptable risk parameters, and to achieve comprehensive, ongoing oversight by branch and head office management. This is perhaps the most important element in the branch lending function. The banking organization, in discharging its duty to both the depositors and shareholders, must ensure that loans in the branch portfolio are made in accordance with the following two objectives:

- To grant loans to creditworthy borrowers for constructive purposes.
- To grant loans that generate income for the benefit of shareholders and the protection of depositors, and in the case of branches, the protection of third parties.

A loan policy will differ from loan procedures. Branches need both to adequately address all areas of lending and loan administration. The lending policy should contain a general outline of the scope of the branch's credit facilities and the manner in which loans are made, serviced, and collected. The policy should be broad in nature and not overly restrictive. The formulation and enforcement of inflexible rules not only stifles initiative but also may hamper profitability and prevent the branch from serving customers' changing needs. A lending policy should provide for the presentation to the head office or a committee thereof, of loans that credit officers believe are fundamentally sound and worthy of consideration, even though they may not conform with certain aspects of the branch's written lending policy. Any exceptions to the lending policy should be approved, documented, monitored and reported to head office. Flexibility must exist to allow for fast reaction and early adaptation to changing conditions in the branch's earning assets mix and within its service area.

The written loan policy is the cornerstone for sound lending and loan administration. An adequate loan policy serves to promote:

- Consistency in business and lending philosophy, despite changes in management.
- Stability as it provides a reference for lending authorities.

- Clarity to minimize confusion concerning lending guidelines.
- Objectivity as it provides sound guidelines for evaluating new business opportunities.

In developing the lending policy, consideration must be given to the branch's business plan, financial resources, and personnel. Typically, a branch's lending policy will be used to describe the branch's mission statement, e.g., facilitating trade transactions with the home country and lending to U.S. subsidiaries of home country corporations.

A lending policy should prohibit discriminatory practices. However, a policy should identify acceptable and unacceptable types of credit and establish prudent underwriting standards, including pricing standards. Other internal factors addressed include granting credit authority, establishing lending limits, and defining organizational structure. As authority is spread throughout its offices, the organization must have an effective method for monitoring adherence to established policy. The testing of credit quality standards can best be accomplished by an internal loan review and reporting function to the head office, which allows senior head office management to monitor adherence to policies and provides information sufficient to evaluate the performance of branch officers and the condition of the loan portfolio. The audit function can also serve to enforce compliance with policies, guidelines, and approved credit administration practices.

## Components for a Sound Lending Policy

The lending policy should require diversification within the portfolio and provide prudent underwriting standards. There are certain components that form the basis for a sound loan policy and should be addressed by every lending institution.

*Aggregate Limits and Distributions by Category*—In order to limit the total amount of loans outstanding, relationships with other balance sheet accounts should be established. Branches usually express controls over the loan portfolio relative to their total claims on nonrelated parties. In setting such limits, various factors, such as credit demand, legal lending

limit, borrower or industry concentration, the volatility of funding and the credit risks involved must be considered. Additionally, limits on aggregate percentages of total loans in commercial, real estate, consumer, or other categories are common. Such policies are beneficial but should allow for deviations with the approval by the head office. This allows credit to be distributed in relation to the changing needs of the target markets.

*Geographic Limits*—A branch's trade area should be clearly delineated and loan officers and senior management should be fully aware of specific geographic limitations for lending purposes. Although many branches will define their trade areas to include a number of states, frequently, the primary calling efforts are focused on a narrower area. Certain types of lending, which require significant knowledge of local market conditions or intensive monitoring of branch personnel, should be carefully considered. Examples include commercial loans to large regional companies, loans to finance commercial real estate projects, or asset based lending that requires regular monitoring of accounts receivables. In addition, the branch's defined trade area should not be so large that, given its resources, proper and adequate monitoring and administration of the branch's credits cannot be reasonably determined.

*Concentrations of Credit*—The loan policy should recognize the need for diversification of risk and establish some parameters on concentrations of loans to industries, 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.

Examiners should recognize that as a part of a larger banking entity, individual branches may have concentrations that are well within proper diversification in the context of the overall organization. Many branches specialize in terms of the kind of business transacted and the types of credits extended. Many credits are trade-related and often reflect the economic makeup of the branch's home country. In addition, credits at the branch are often booked at the direction of the head office and can reveal concentration by industry, country, or borrower. Nonetheless, branches, as part of a sound risk management system, must establish procedures for identifying

and monitoring inherent risk resulting from concentrations of credit.

Institutions that have effective controls in place to manage and reduce undue concentrations need not refuse credit to sound borrowers simply because of the borrower's industry or geographic location. It is important to emphasize that this principle applies to loan renewals, rollovers, and new extensions of credit.

*Types of Loans*—The lending policy should state the types of loans that the branch will make and should set forth guidelines to follow in making specific loans. The decision about the types of loans to be granted should be based on a consideration of the business plan, expertise of the lending officers and support personnel, the funding structure of the branch, and anticipated credit demands of the target markets. Credits involving complex structures or repayment arrangements or loans secured by collateral that require more than normal policing should be avoided unless or until the branch obtains the necessary personnel, policies, controls, and systems to properly administer such loans. Types of credits that have resulted in an abnormal loss to the branch should be identified, scrutinized, and controlled within the framework of stated policy.

*Repayment Terms and Maximum Maturities*—Loans should be granted with realistic repayment plans. Maturity scheduling should be 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 the original terms of a loan. If the branch requires a cleanup (out-of-debt) period for lines of credit, the period should be explicitly stated.

*Loan Pricing*—Rates on various loan types established by the loan policy must be sufficient to cover the costs of the funds loaned, of servicing the loan, including general overhead and of probable losses while providing for a reasonable margin of profit. Policy makers must know those costs before establishing rates that arise out of an effective risk management process. Periodic review allows the rates to be adjusted to reflect changes in costs, competitive factors, or the risks associated with the type of extension of credit. Specific guidelines for other

relevant factors, such as commitment fees, are also germane to pricing policy.

*Documentation and Collateral*—Trade financing often represents a significant amount of the branch's lending activity. In such financing, the branch deals only in documents while its customer is responsible for the merchandise under the terms of the contract. The branch's control of documents, especially title documents, is crucial. There are significant differences between domestic loan agreements and foreign ones. Nevertheless, the branch must ensure that it is adequately protected through loan agreements with foreign borrowers. The loan agreement should also protect against adverse changes in foreign tax rules, loan funding problems, and additional withholding and other types of taxes. The branch should have policies for taking foreign collateral as security for a loan to assure adherence with the local required procedures. For example, liens on fixed assets in many countries must be registered with the local government.

*Maximum Ratio of Loan Amount to Collateral Value or Acquisition Costs*—The branch's lending policy should identify where the responsibility for appraisals or internal evaluations lies and should define formal, standard appraisal, and evaluation procedures, and procedures for possible reappraisals or reevaluations in the case of renewals or extensions. Acceptable types of appraisals or evaluations should be listed. The policy should also include the limits on the dollar amount and type of real or personal property that branch personnel are authorized to appraise. Circumstances regarding the use of in-house appraisers versus a fee appraiser should be identified. The ratio of loan amount to the value of the collateral, the method of valuation, and the differences for various types of property should be detailed.

*Financial Information*—Extending credit on a safe and sound basis depends on complete and accurate information regarding the borrower's credit standing. One exception is when the loan is predicated on readily marketable collateral, the disposition of which was originally designated as the source of repayment for the advance. Current and complete financial information is necessary not only at the inception of the credit but also throughout the term of the credit. The lending policy should define the requirements of

financial statement information for various types of credit extended by the branch. In addition, the lending policy should define the requirements for financial statements and operating data for businesses and individuals at various borrowing levels and should include requirements for audited, non-audited, annual, interim, income, cash flow and other financial statements, tax returns, changes in owner's equity and other supporting notes, schedules, and management analyses. Financial statement requirements should include external credit checks required at the time of periodic updates. The policy should define the financial requirements in such a manner that any credit data exception in an examination report should be a clear contravention of the branch's lending policy.

Financial statements for foreign borrowers or guarantors may present additional risks or problems not associated with domestic borrowers. Foreign customers' financial statements may be prepared in either U.S. dollar equivalents or in the borrower's local currency. Most branches analyze the latter statements, particularly if that currency is unstable, therefore figures stated in U.S. dollar equivalent amounts would be distorted by the conversion rates used at various times. Sometimes, the branch may need to reconstruct a borrower's financial statement in U.S. dollar equivalents to reflect the borrower's financial strength and weaknesses more accurately. Since the financial information may not be reliable, the branch's policies should enable it to determine by other means the capacity, integrity, and experience of the foreign borrower. While analyzing foreign borrowers' financial statements, examiners should take into consideration the differences in foreign accounting practices from the generally accepted accounting principles (GAAP) in the United States.

*Limits on Country Exposures*—The loan policy should define maximum exposures to countries other than the United States. All sizeable exposures should be supported by country analyses and other supporting information. Country limits should be consistent with the creditworthiness of the respective countries.

*Limits and Guidelines for Purchasing and Selling Loans Either Directly or Through Participations or Swaps*—If sufficient loan demand exists, lending within the branch's trade area is safer and less expensive than purchasing paper from another bank. Direct lending promotes

customer relationships, serves the credit needs of customers, and develops additional business. In some instances, however, a branch may not be able to make a loan to a customer for the full amount requested because of prudential lending limitations or other reasons. In such situations, the branch may extend credit to its customer for the full amount needed and sell or participate out that portion that exceeds the branch'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 to the branch and the originating and purchasing institutions 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 branch to retain customers who might otherwise seek credit elsewhere.

Conversely, many branches purchase loans or participations in loans originated by other organizations. The policy should require that loans purchased from another source be evaluated in the same manner as loans originated by the branch itself. Generally, the branch should avoid concentrations in purchasing loans from any one outside source or concentrations in purchases of loans to any one industry.

Purchasing and selling loans can have a legitimate role in a branch's asset and liability management and can contribute to the efficient functioning of the financial system. In addition, these activities can assist a branch in diversifying its risks and improving its liquidity.

The policy should state the limits for the aggregate amount of loans purchased from and sold to any one outside source and for all loans purchased and sold. Limits should also be established for the aggregate amount of loans to particular types of industries that may be purchased. Guidelines should be established for the type and frequency of credit and other information that should be obtained from the lead institution in order to keep the branch continually updated on the financial condition of the borrower and the status of the credit. Because of the inherent reliance on the lead institution to administer and collect participated loans, the purchasing branch should evaluate the lead institution's ability to properly carry out these responsibilities. Conversely, guidelines should also be established for supplying complete and regularly updated credit information to the

purchasers of loans originated and sold by the branch.

*Loan Authority*—The lending policy should establish limits for all lending officers. In many branches of FBOs, most lending authority remains with the head office. If lending policies are clearly established and enforced, individual officer limitations may be somewhat higher, based on the officer's experience and tenure with the branch. Frequently, group lending limits are set, allowing a combination of officers or a committee to approve larger loans than the members would be permitted to approve individually. The reporting procedures and the frequency of committee meetings should be defined.

*Collections, Charge-Offs, and Specific Reserves*—The lending policy should define delinquent obligations and contain guidelines for placing loans on nonaccrual status and initiating foreclosure proceedings. Delinquency status is determined by the contractual terms and defined as when the principal or interest on an asset becomes due and unpaid for 30 days or more. For regulatory reports, branches must comply with the reporting requirements for past due and nonaccrual loans. Additionally, the policy should dictate the appropriate reports to be submitted to the head office concerning those obligations. The reports should include sufficient detail to allow for the determination of the loss potential and alternative courses of action. The policy should require 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 head office for charge-offs or specific reserves in accordance with applicable regulatory policy.

*Legal Lending Limits*—The lending policy may describe limitations on loans to one borrower, as are consistent with head office and/or federal requirements. The Foreign Bank Supervision Enhancement Act of 1991 superseded state legal lending limits to the extent that exposures to a single borrower by all state and federal branches of the same FBO must be aggregated and applied against the capital of the FBO (12 USC 84.)

*Other*—The lending policy should be supplemented with other written guidelines for specific departments of the branch. Written policies and

procedures approved and enforced in various departments should be referenced in the general lending policy of the branch.

Management should establish appropriate policies, procedures, and information systems to ensure that the impact of the branch's lending activities on its interest rate exposure is carefully analyzed, monitored, and managed. In this regard, consideration should also be given to the risks associated with off-balance sheet instruments related to lending arrangements, such as loan commitments and swaps.

## Approval Process

In addition to the components that form the basis for a sound lending policy, there should be a documented approval process for exceptions to that policy, including the need for approval of exceptions by the head office. Management information systems should report and highlight loan exceptions to branch management and the head office.

Before a branch extends credit, its objectives, policies, and practices must be clearly established. Before examining a loan department, those objectives, policies, and practices should be reviewed by the examiner to determine if they are reasonable and adequate to properly supervise the portfolio. The absence of written guidelines is a major deficiency in the lending area and may indicate that the branch is not being properly supervised by its head office. The various credit extending areas should be examined to determine compliance with objectives, policies, and practices, which is a prime examination objective.

## Loan Information Systems

The loan information system should include the loan policy and loan administration procedures, loan documentation maintained for borrowers, reports prepared for the benefit of senior management at the branch or at the head office, the loan grading and loan review system, and the system to manage problem loans.

Loan information and documentation should demonstrate that the borrower has the ability and willingness to repay the loan. These documents should also indicate that the lending officer has adhered to sound lending practices,

acted prudently to safeguard the branch's funds, and ensured repayment of the loan by all reasonable means. Loan information and other documentation supporting an extension of credit should be in English to enable the examiner to properly evaluate the quality of the credit.

In general, loan documents should provide answers to the following questions:

- Who is the borrower, including ownership and affiliations?
- How did the borrower come to the branch?
- What is the borrower's business?
- What is the purpose of the credit?
- What are the primary and secondary sources of repayment?
- What is the borrower's financial condition?
- What are projections for the borrower's future financial performance?
- How has the borrower performed on other credit obligations?
- What is the collateral for the loan, its location, value, and condition?

If guarantees are involved, the branch must have sufficient information on the guarantor's financial condition. Income, liquidity, cash flows, contingent liabilities, and other relevant factors should be evaluated, including credit ratings, when available, to demonstrate the guarantor's financial capacity to fulfill the obligation. Generally, however, loan quality should be evaluated based on the primary source of payment not secondary sources, such as guarantees. In this respect, guarantees from head office are not viewed as providing support to a loan.

An effective system to obtain and maintain complete and current loan information and documentation is a necessary component of sound lending. Failure to establish and enforce this system will increase credit risk and cause the branch to suffer losses that could have been avoided.

Before the loan is funded, the branch must ensure that all the required documentation is current. It is generally easier to ensure complete and current documentation before the loan is funded, as the borrower will be cooperative and the loan has the lending officer's full attention.

To ensure on-going attention to documentation, the loan policy should require the branch to obtain and maintain current documentation on borrowers and collateral. The loan policy should also ensure that loan documentation is reviewed

periodically and any exceptions are addressed promptly.

## INTERNAL LOAN REVIEW

### Key Loan Review Objectives

Depending on the branch's size, its lending activities, and management philosophy, loan review may be handled by a part-time person, one person, an independent contractor, or a separate department staffed by a number of employees at the branch, at a regional U.S. office, or at the head office. An important ingredient of loan review is that it must be independent from the approval process. Regardless of how loan review is structured, a satisfactory loan review system should have the following objectives:

- Provide an objective grading system for loans.
- Provide current information regarding portfolio risk to branch management and the head office on a timely basis.
- Identify problem credits and place them under additional scrutiny.
- Assist in the evaluation of the adequacy of specific and general reserves in accordance with applicable regulatory policy.<sup>1</sup>
- Evaluate trends in the loan portfolio.
- Cite loan policy exceptions and noncompliance with procedures.
- Cite documentation exceptions.
- Cite violations of laws and regulations.
- Assist in the development and revision of policy and procedures.
- Act as an information source concerning emerging trends in the portfolio and the branch's lending areas.

### Loan Review Reporting

Loan review reporting must be thorough, accurate, and timely to provide sufficient information to allow management and the head office to both

1. Branches are not required to maintain an allowance for loan losses for Federal Reserve supervisory purposes. However, it is recognized that the licensing and insuring authorities may require U.S. branches to maintain such reserves under their respective jurisdictions to fulfill the requirements of their individual licensing or insurance statutes, or to satisfy other specific concerns of the authority.

identify and control risk. At a minimum, there should be three types of reporting required from loan review: file memoranda, head office reports, and an annual schedule or loan review plan.

File memoranda are completed after each loan is reviewed and are placed in the credit file to document the reviewer's conclusions. Loan grades and supporting facts should be included, along with any instances of noncompliance with the branch's policy, procedures and applicable regulations. Documentation exceptions should also be indicated.

If the process is conducted by the lending officers themselves, then compliance with policies and procedures is best determined by another branch department, such as internal audit.

Head office/management reports are summaries of the loan reviewer's conclusions regarding the quality of the portfolio or segment of the portfolio. These reports should state the scope of the review; the distribution of loan grades for the portfolio or segment of the portfolio; the percentage of both collateral and financial documentation exceptions; all instances of noncompliance with policies, procedures, or regulations; an assessment of the overall quality of the portfolio; and the resulting impact on the allowance for loan losses, where applicable, and any other factors that might have an adverse effect on the portfolio.

These reports should go to head office management. If applicable, a copy of these reports can also be given to U.S. regional management, the manager of the loan department, and the branch's executive management; however, management should not be allowed to influence the content of the report. The head office should be given this report on a timely basis and require lending officers to correct and respond to all significant problems and exceptions within a specified time frame.

Although a good loan review system is important to ensure sound lending and strong loan administration, excessive reliance should not be placed on this system. It is always the lending officers' responsibility to maintain sound underwriting standards and loan quality. It is also their responsibility to monitor the portfolio on an ongoing basis and to initially identify problem credits. Loan review should not be the first line of defense to identify emerging problems. Its primary responsibility is to identify weaknesses in lending and loan administration and their underlying causes.

## Loan Problems

The failure of branch and head office management to establish a sound lending policy, to establish adequate written procedures, and to monitor and administer the lending function within established guidelines may result in substantial problems for the branch. Loan problems may be caused by a number of factors affecting the branch or its borrowers, such as the following:

*Anxiety for Income*—The loan portfolio is usually the branch's most important revenue producing asset. However, the pursuit of earnings must never be permitted to override sound underwriting principles by extending credit that carries undue risks or unsatisfactory repayment terms. Over the long term, unsound loans usually cost far more than the revenue they produce.

*Compromise of Credit Principles*—Branch management, for various reasons, may knowingly grant loans carrying undue risks or unsatisfactory terms in violation of its own underwriting standards. These reasons may include head office relationships with associated companies of the branch's customer. Self-dealing, anxiety for income, inappropriate salary incentives, bonuses based on loan portfolio growth, and competitive pressures may also lead to a compromise of sound credit principles.

*Incomplete Credit Information*—Character and capability may be determined by many means but complete credit information is the only acceptable and reasonably accurate method for determining a borrower's financial condition. The lack of sufficient financial information is an important cause of problem credits. Current and complete comparative financial statements, operating reports, and other pertinent statistical support should be available. Other essential information, such as the purpose of the borrowing, the intended plan and source of repayment, progress reports, inspections, and memoranda of outside information and loan conferences, should be contained in the branch's credit files. Proper credit administration and accurate credit appraisals are not possible without such information.

The Interagency Policy on Documentation of Loans by U.S. Branches and Agencies of Foreign Banks, which was issued on May 14, 1993,

exempts these branches from certain documentation requirements for credits to small and medium-sized businesses and farm loans. (Refer to the policy statement for specific limitations.)

*Failure To Obtain or Enforce Repayment Agreements*—Loans granted without a clear written agreement governing repayment violate a fundamental banking principle that frequently is a major cause of problem loans. Another common cause of problem loans is when scheduled payments or reductions are not collected in accordance with the terms of the loan agreement.

*Inadequate supervision of familiar borrowers.*

*Over-reliance on verbal information furnished by borrowers in lieu of reliable financial data.*

*Downplaying of known credit weaknesses because of the borrower's past history of overcoming recurrent hazards and distress.*

*Ignoring warning signs pertaining to the borrower, economy, region, industry, or other related factors.*

*Lack of Supervision*—Many loans that are sound at inception have developed into problems and losses because of lack of effective on-going supervision.

*Technical Incompetence*—Able and experienced bankers should possess the technical ability to analyze financial statements and to obtain and evaluate other credit information. Technical incompetence often results in unexpected losses.

*Overlending*—Loans granted beyond the borrower's reasonable capacity to repay are inherently unsound. Technical competence and sound credit judgment are necessary in determining a sound borrower's safe, maximum loan level.

*Competition*—Competition among branches for size and market share may result in the compromise of credit principles and the funding of unsound loans.

## Nonaccrual and Restructured Loans

Working in a prudent manner with borrowers that are experiencing financial difficulties, branch

management may restructure loans or take other measures in recognition of borrowers' condition and repayment prospects. Such actions, if done in a way that is consistent with prudent lending principles and supervisory practices, can improve a branch's prospects for collection. Generally accepted accounting principles (GAAP) and regulatory reporting requirements provide a framework for working in a constructive fashion with borrowers experiencing financial difficulties.

The Interagency Policy Statement on Credit Availability, issued on March 1, 1991, presented clarifications of a number of supervisory policies regarding issues relating to nonaccrual assets and restructured loans. These clarifications indicated that when certain criteria are met: (a) interest payments on nonaccrual assets can be recognized as income on a cash basis, without first recovering any previous partial charge-offs; (b) nonaccrual assets can be restored to accrual status when subject to formal restructuring in accordance with Financial Accounting Standards Board (FASB) Statement No. 15; and (c) restructuring that yields a market rate of interest would not have to be included in restructured loan amounts reported in the years subsequent to the year of the restructuring.

## Nonaccrual of Interest

Loans and lease financing receivables are to be placed in nonaccrual status if:

- They are maintained on a cash basis because of deterioration in the financial condition of the borrower.
- Payment in full of principal or interest is not expected; or
- Principal or interest has been in default for a period of 90 days or more, unless the loan is both well secured and in the process of collection.

A debt is well secured if it is secured (a) 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 (b) by the guarantee of a financially responsible party. A debt is in the process of collection if collection of the asset is proceeding in due course either through legal action,

including judgment enforcement procedures or, 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.

*Treatment of Cash Payments and Criteria for the Cash Basis Recognition of Income*—When doubt exists as to the collectibility of the remaining book balance of a loan in nonaccrual status, any payments received must be applied to reduce principal to the extent necessary to eliminate such doubt. Placing an asset in nonaccrual status does not, in and of itself, require a charge-off, in whole or in part, of the asset's principal. However, identified losses must be charged-off. When a loan is in nonaccrual status, some or all of the cash interest payments received may be treated as interest income on a cash basis if the remaining book balance of the asset, after a charge-off, if any, is deemed to be fully collectible. A branch's determination as to the ultimate collectibility of the asset's remaining book balance must be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment, including consideration of the borrower's historical repayment performance and other relevant factors.

When recognition of interest income on a cash basis is appropriate, the amount of income that is recognized should be limited to that which would have been accrued on the loan's remaining book balance at the contractual rate. For a formally restructured loan, the effective interest rate should be used. Any cash interest payments received in excess of this limit, and not applied to reduce the loan's remaining book balance, should be recorded as recoveries of previous charge-offs, until these charge-offs have been fully recovered.

*Restoration to Accrual Status*—According to the Revised Interagency Guidance on Returning Certain Nonaccrual Loans to Accrual Status issued June 10, 1993, nonaccrual loans may be returned to accrual status, even though the loans have not been brought fully current, provided two criteria are met: (1) all principal and interest amounts contractually due, including arrearages, are reasonably certain of repayment within a reasonable period and (2) there is a sustained period of repayment performance (generally a minimum of six months) by the borrower, in

accordance with the contractual terms, involving payments of cash or cash equivalents. However, loans that meet these criteria would continue to be disclosed as past due and still accruing for purposes of the Report of Assets and Liabilities (call report), until they have been brought fully current.

For purposes of meeting the first test, the branch must have received repayment of the past due principal and interest unless, as discussed below, the loan has been formally restructured and qualifies for accrual status or the asset has been acquired at a discount (because there is uncertainty as to the amounts or timing of future cash flows) from an unaffiliated third party and meets the criteria for amortization, i.e., accretion of discount, specified in AICPA Practice Bulletin No. 6.

Until the loan is restored to accrual status, cash payments received must be treated in accordance with the criteria stated above. In addition, after a formal restructuring, if a restructured 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 reasons, the asset must be placed in nonaccrual status. Under GAAP, when a charge-off was taken before the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

*Treatment of Multiple Extensions of Credit to One Borrower*—As a general principle, nonaccrual status for an asset should be determined based on an assessment of the individual asset's collectibility and payment ability and performance. Thus, when one loan to a borrower is placed in nonaccrual status, a branch does not have to place all other extensions of credit to that borrower in nonaccrual status. When a branch has multiple loans or other extensions of credit outstanding to a single borrower, and one loan meets the criteria for nonaccrual status, the branch should evaluate its other extensions of credit to that borrower to determine whether one or more of these other assets should also be placed in nonaccrual status.

*Examiner Review*—Some states have promulgated regulations or adopted policies for

nonaccrual of interest on delinquent loans, which may differ from the above procedures. In such cases, the branch should comply with the more restrictive policy. The examiner should ensure that the branch is complying with such guidelines. In all instances, whether or not there is a formal policy, each branch should formulate its own policies to ensure that income is not being overstated. The examiner should review the branch's specific policy to ensure that it is prudent.

When a branch places a loan in nonaccrual status, it must determine an appropriate treatment for previously accrued but uncollected interest and subsequent payments. One acceptable 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, all interest previously recognized, if accrued interest provisions had not been provided, would be reversed (expensed) against current earnings.

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 branch is expected to have a well-defined policy governing the write-off of accrued interest receivable.

### Treatment of Nonaccrual Loans with Partial Charge-offs

Questions have been raised regarding whether partial charge-offs associated with a nonaccrual loan (that has not been formally restructured) must first be fully recovered before a loan can be restored to accrual status. GAAP and regulatory reporting requirements do not explicitly address this issue.

When a loan has been brought fully current with respect to contractual principal and interest and the borrower's financial condition and prospects for repayment have improved so that the full amount of 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. On the other hand, this treatment would not be appropriate when the charge-off is indicative of continuing doubt regarding the collectibility of principal or interest. Because the criteria for

nonaccrual status include the requirement that loans or other assets be placed in nonaccrual status when repayment in full of principal or interest is not expected, such nonaccrual loans should not be restored to accrual status.

It is imperative that the reasons for the restoration of a partially charged-off loan to accrual status be documented. Such 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.

### Renegotiated Troubled Debt

Renegotiated troubled debt includes those loans and lease financing receivables that have been restructured or renegotiated to provide concessions to the borrower, e.g., a reduction of interest or principal payments because of a deterioration in the financial position of the borrower. 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 Financial Accounting Standards Board Statement No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructuring, (FASB Statement No. 15).

Branches should develop a policy relative to renegotiated troubled debt to ensure that such items are identified, monitored, and properly handled from an accounting and control standpoint. Such items should be relatively infrequent in occurrence. If not, the branch is probably experiencing significant problems. Before such concessions are made to a borrower, it is good practice to have the transactions receive prior approval of the head office. All such transactions should be reported to the head office upon enactment.

### Nonaccrual Assets Subject to FASB Statement No. 15 Restructuring

The Policy Statement on Credit Availability Issues indicated that a loan or other debt instrument that has been formally restructured, so as to be reasonably certain of repayment and

performance according to its modified terms in accordance with a reasonable repayment schedule, need not be maintained in nonaccrual status. Furthermore, the policy statement indicated that, in returning the asset to accrual status, sustained historical payment performance for a reasonable time before the restructuring may be taken into account.

For example, a loan may have been restructured, in part, to reduce the amount of the borrower's contractual payments. In so doing, the borrower's restructured terms may require payments that do not exceed the amount and frequency that have been demonstrated by the sustained historical payment performance of the borrower for a reasonable time before the loan was restructured. In this situation, assuming that the restructured loan is reasonably certain of repayment and performance according to its modified terms, the loan can be immediately restored to accrual status.

Clearly, a period of sustained performance, whether before or after the date of the restructuring, is an important factor in determining whether there is reasonable assurance of repayment and performance according to the loan's modified terms. In certain circumstances, evidence may exist regarding other characteristics of the borrower that may be sufficient to demonstrate a relative improvement in the borrower's condition and debt service capacity, thereby reducing the degree of reliance on the borrower's performance to date in assessing prospects for future performance and collectibility under the modified terms. For example, substantial and reliable sales, lease, or rental contracts obtained by the borrower, or other important developments that are expected to significantly increase the borrower's cash flow and debt service capacity and strengthen the borrower's commitment to repay, may be sufficient to provide this assurance. In certain circumstances, a preponderance of such evidence, in and of itself, may be sufficient to warrant returning a restructured loan to accrual status, provided the loan under its restructured terms is reasonably certain of performance and full collectibility.

It is imperative that the reasons for the restoration of restructured debt to accrual status be fully documented. Such actions should be supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This documentation will be subject to

review by examiners.

The formal restructuring of a loan or other debt instrument should be undertaken in ways that improve the likelihood that the credit will be repaid in full under the modified terms in accordance with a reasonable repayment schedule. When a restructured loan is not reasonably certain of repayment and performance under its modified terms in accordance with a reasonable repayment schedule, the loan may not be restored to accrual status.

When restructuring loans, regulatory reporting requirements and GAAP do not require banking organizations to grant excessive concessions, forgive principal, or take other steps not commensurate with the borrower's ability to repay in order to use the reporting treatment specified in FASB Statement No. 15. Furthermore, regulatory reporting requirements and GAAP do not preclude institutions from including prudent contingent payment provisions in the restructured terms that permit an institution to obtain appropriate recovery of concessions involved in the restructuring, should the borrower's condition substantially improve.

A nonaccrual loan or debt instrument may have been formally restructured in accordance with FASB Statement No. 15 so that it meets the criteria for restoration to accrual status presented in the previous section that addresses restructured loans. Under GAAP, when a charge-off was taken before the date of the restructuring, the charge-off does not have to be recovered before the restructured loan can be restored to accrual status. When a charge-off occurs after the date of the restructuring, the considerations and treatments discussed in the previous paragraphs in this section are applicable.

## Reporting of Loan Fees and Interest

The accounting standards for nonrefundable fees and costs associated with lending, commitments 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. The statement applies to all types of loans and to debt securities but not to loans or securities carried at market value and to all types of lenders. It must be applied to all lending and leasing transactions in fiscal years beginning after December 15,

1987, but retroactive application is permitted. For further information, see FASB Statement No. 91.

All other lending-related costs, whether or not incremental, should be charged to expense as incurred, including costs related to activities performed by the lender or by independent third parties for the lender, for advertising, identifying potential borrowers, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration. Employees' compensation and fringe benefits related to these activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Net unamortized loan fees represent an adjustment of the loan yield and shall be reported in the same manner as unearned income on loans, i.e., deducted from the related loan balances, to the extent possible, or deducted from total loans in any unearned income on loans in the call report, which provides a breakdown of various types of loans. Net unamortized direct loan origination costs shall be added to the related loan balances. Amounts of loan origination, commitment, and other fees and costs recognized as an adjustment of yield should be reported under the appropriate Interest income item in the income statement. Other fees, such as fees that are recognized during the commitment period or included in income when the commitment expires, i.e., fees, retrospectively determined, and fees for commitments, where exercise is remote, and (b) syndication fees that are not deferred, should be reported as other noninterest income.

## Other Lending Concerns

The transfer of low quality loans from one depository institution to another may be made to avoid detection and classification during regulatory examinations. Transfer may be accomplished through participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated financial institutions. Examiners should be alert to situations where a branch's intention seems to be the concealment of low quality

assets for the purpose of avoiding examination scrutiny and possible classification.

During branch examinations, examiners should identify situations where low quality assets have been transferred between the branch being examined and another U.S. branch of a foreign bank or other depository institution. Low quality loans, broadly defined, include loans that are classified or specially mentioned or if subjected to review would most likely be classified or specially mentioned, 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 that the examiner believes are of questionable quality.

## Examining the Lending Function

The results of the loan examination should provide the examiner with a method of arriving at an overall evaluation for the entire branch loan portfolio. Historically, examination results have identified problems in the loan area through a detailed review of credits and credit documentation. The examiner should also correlate the following items with the overall system of policies, practices, procedures, and controls instituted by the branch to prevent such problems:

- Identified problem credits.
- Unsafe or unsound lending procedures.
- Past due loans.
- Credit documentary exceptions.
- Violations of laws and regulations.
- Concentrations of credit.
- Evidence of self-dealing loan transactions.
- Collateral documentary exceptions.

The purpose of this correlation is to determine causes of existing problems and weak situations, which represent a potential weakness in the branch's risk management process.

The examiner performing the procedures in this section should make the final decision as to the quality of the entire portfolio, the quality of management review and controls, and the scope and adequacy of internal guidelines. A great deal of judgment is necessary in making those decisions because they significantly affect the overall conclusions reached by the examiner-in-charge. The process of compiling information generated, analyzing it, and formulating conclusions about the causes of existing deficiencies,

requires considerable thought and judgement on the part of the examiner. The ultimate conclusions concern the risk management of the lending function, as it now exists, and as it is projected for the future. Furthermore, the examiner is expected to discern causes of existing and potential problems, to capulize the causes and effects, and to present the problems to branch management in such a manner as to obtain positive corrective action.

## Regulatory Compliance

Branches are expected to comply with laws, regulations, and applicable regulatory policy in all aspects of their lending programs. Moreover, branches 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 applicable lending limits, the examiner should review the branch's lending practices in accordance with the applicable state laws in the following areas that prescribe limits on aggregate advances to a single borrower and related borrowers.

*Commissions or Gifts for Procuring Loans.* A branch officer, employee, agent, or attorney should not receive anything of value for procuring or endeavoring to procure a loan, which is prohibited under 18 USC 215.

*Political Contributions.* Loans made in connection with any election to any political office should comply with applicable state banking laws and regulations and with the Foreign Corrupt Practices Act of 1977 (Pub. L. 95-213, 91 Stat. 1494 (1977), 15 USC 78dd-1 and 2, 78m, 78o, and 78ff) and the Federal Election Campaign Act (2 USC 441b).

*Loans to Executives, Officers, and Principal Shareholders of Correspondent Banks.* No preferential treatment should be given to loans to insiders of correspondent banks nor should there be the appearance of a conflict of interest. The branch should comply with Title VIII of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) (12 USC 1972(2)).

*Appraisals and Evaluations.* Federally-insured branches should obtain an appraisal or evaluation for all real estate-related financial transactions prior to 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). Appraisal and evaluation requirements are separately discussed in the Real Estate Appraisals and Evaluations part of this section.

*Consumer Compliance.* The residential lending program at a federally-insured branch 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 federally insured branch'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).

*Credit Life Insurance Income.* The branch's sale of mortgage life insurance in connection with its real estate lending activity should comply with the sales practices, sales commission limits, and disclosure requirements as defined in the Federal Reserve's policy statement on the disposition of credit life insurance income (67 Federal Reserve Bulletin 431 (1981), FRRS 3-1556).

# Credit Risk Management

## Examination Objectives

Effective date July 1997

## Section 3010.2

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1. To determine if policies, practices, procedures, and internal controls regarding credit risk management are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To determine the scope and adequacy of the audit and loan review functions.
4. To determine the overall quality of the loan portfolio and how that quality relates to the risk management function of the branch.
5. To prepare information regarding the branch's lending function in 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 applicable law or regulations have been noted.

# Credit Risk Management

## Examination Procedures

Effective date July 1997

## Section 3010.3

The following procedures are intended to determine that the branch under examination has established satisfactory procedures to ensure that controls regarding credit risk management are adequate. Examiner discretion is required in applying these procedures. Before beginning the assignment, the examiner should review the scope memorandum and consult with the examiner-in-charge or other designated individual to determine the scope of the review. Some of the procedures may not be necessary, based on the quality of the branch's internal controls or the nature and level of activity in the area.

1. If selected for implementation, complete, or update the Internal Control Questionnaire for this section.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
3. Reconcile the customer central liability ledger or subsidiary loan ledgers to the general ledger.
4. Obtain the branch's internal listing of Shared National Credits and verify ratings with regulatory records.
5. Review the branch's lending policies to determine:
  - a. If the policies are adequate for the size, nature, and business of the bank.
  - b. If the branch is in compliance with its policies.
  - c. If the policies are reviewed and updated periodically to ensure they are relevant with changing market conditions and new business lines of the bank.
  - d. If policies have been approved by the head office.
6. If applicable, review minutes of the branch's loan committee meetings to determine:
  - a. Current members and their attendance record.
  - b. Scope of work performed.
  - c. Any information deemed useful in the examination of specific loan categories or other areas of the branch.

## LOAN REVIEW

In general, a loan review program should provide an independent means to identify credit and loan administration weaknesses, provide accurate and timely reports to management detailing weaknesses discovered, and provide a means for recognizing potential problems.

7. Determine if the loan review program ensures independence from the lending function including whether:
  - a. Policies specifically address the separation of loan review from the lending and credit approval functions.
  - b. The loan review function reports directly to the head office, a regional office, or a senior branch officer not involved in the lending function. If not, determine if the branch has adequate controls to ensure independence from the lending function.
8. Determine if the frequency of loan review is adequate, and if the program includes:
  - a. A minimum frequency of reviews.
  - b. A frequency which is sufficient to provide timely information concerning emerging trends in the portfolio and general economic conditions.
  - c. Increased frequency for identified problem credits.
9. Evaluate the adequacy of the scope of the loan review, including:
  - a. Method of loan selection.
  - b. Manner in which loans are reviewed, including:
    - an analysis of the current financial condition of the borrower which addresses repayment ability, and
    - tests for documentation exceptions, policy exceptions, noncompliance with internal procedures, and violations of laws and regulations.
10. Assess the qualifications of the personnel involved in the credit review function.
11. Evaluate the loan review reporting system including credit file memoranda, head office reports, and an annual schedule or loan review plan, to ensure it is thorough, accurate and timely and will provide sufficient information to allow management and the head office to both identify and control risk.

Determine if the reports include:

- a. Identification of problem credits.
- b. Current information regarding portfolio risk.
- c. Information concerning emerging trends in the portfolio and the branch's lending areas.

- h. The accuracy and completeness of reports submitted to the head office or regional office.
  - i. Competency of senior management, loan officers and credit administration personnel.
15. Determine, through information previously generated, the causes of existing problems or weaknesses within the system, which present potential for future problems.

## CREDIT GRADING SYSTEM

12. Assess the adequacy of the credit grading system and determine if it:
  - a. Includes an objective grading system for loans.
  - b. Contains explicit definitions of the branch's internal grading system, and that it is easily understood by all lenders and loan review staff.
  - c. Designates who has ultimate authority to assign and change credit grades.
13. Evaluate the accuracy of the branch's credit grading system by comparing the credit grade assigned by the branch with those assigned by examiners. Determine the extent of management's knowledge of its own loan problems.

## GENERAL CREDIT RISK ADMINISTRATION

14. Assess the effectiveness of the branch's credit administration and portfolio management by evaluating:
  - a. Management's general lending philosophy in such a manner as to elicit management responses.
  - b. The volume and magnitude of differences in grades assigned by the branch and by the examiners.
  - c. The impact of credits not supported by current and complete financial information and analysis of repayment ability.
  - d. The impact of credits for which loan and collateral documentation are deficient.
  - e. The volume of loans improperly structured, e.g., repayment schedule does not match loan purpose.
  - f. The volume and nature of concentrations of credit, including concentrations of classified and criticized credits.
  - g. The appropriateness of transfers of low quality credits to or from another affiliated office.

## PROBLEM LOAN ADMINISTRATION

16. Determine if the branch has adequate policies and procedures for problem and work-out loans, including:
  - a. A periodic review of individual problem credits.
  - b. Guidelines for collecting or strengthening the loan, including requirements for updating collateral values and lien positions, documentation review, officer call reports.
  - c. Volume and trend of past due or nonaccrual credits.
  - d. Qualified officers handling problem loans.
  - e. Guidelines on proper accounting for problem loans, e.g., non-accrual policy; specific reserve policy.

## COMPLIANCE

17. Assess the branch's compliance with laws and regulations, by determining whether:
  - a. The branch has loans to affiliates (Section 23A of the Federal Reserve Act).
  - b. A bank officer or employee received anything of value for procuring or endeavoring to procure any extension of credit (18 USC 215 for Commission or Gift for Procuring a Loan).
  - c. The branch has a stated purpose for each loan over \$10 thousand, except those secured by real estate (31 CFR 103.33(a) of the Bank Secrecy Act).
  - d. The branch is in compliance with state and federal lending limits, as described in Regulation K, or specific statutes.
  - e. The branch is in compliance with Regulation O regarding loans to insiders. (applicable to FDIC-insured branches only).

18. Forward any violations of law to the examiner in charge of compliance, and include a cross reference here.

### SPECIFIC RESERVES

19. Ensure that any specific reserves reported by the branch are appropriate, i.e., based on a specific loss amount that has been identified for an individual credit.
20. Determine if the branch accounts for specific reserves appropriately when the underlying asset has been transferred, sold, or paid off.
21. Review the management reports submitted to the head office, to determine that reports are sufficiently detailed to evaluate risk factors.
22. Summarize your findings being sure to consider the following:
  - a. Check for noncompliance with internal policies, practices, procedures, and controls. Determine if instances of noncompliance are system-wide or limited to a specific area.
  - b. Organize exceptions in order of relative importance.
  - c. Organize and prepare a listing of violations of laws and regulations.
  - d. Determine the aggregate amount of loans criticized in each of the four levels of criticism.
- e. Compile a listing of all loans not supported by current and complete credit information and collateral documentation.
- f. Compile a listing of low quality loans transferred to or from another lending institution through purchases/sales, participations, or swaps.
23. Discuss results of the examination of the lending function with senior management, structuring inquiries in such a manner as to:
  - a. Elicit management responses for correction of deficiencies.
24. Write, in appropriate report format, general remarks including:
  - a. The scope of the examination of the lending function.
  - b. The quality of internal policies, practices, procedures, and controls over the lending function.
  - c. The general level of adherence to internal policies, practices, procedures, and controls.
  - d. The scope and adequacy of the internal loan review system.
  - e. The quality of the entire loan portfolio.
  - f. The competency of management with respect to the lending function.
  - g. Causes of existing problems.
  - h. Expectations for continued sound lending or correction of existing deficiencies.
25. Prepare a complete set of workpapers to support conclusions, and discuss all material findings with management.

# Credit Risk Management

## Internal Control Questionnaire

Effective date July 1997

## Section 3010.4

Review the branch's internal controls, policies, practices, and procedures for managing the loan portfolio. The 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. Has a policy for credit risk management been adopted that specifically:
  - a. Establishes suggested guidelines for distribution of loans in the commercial, real estate, and other categories?
  - b. Establishes geographic limits, including country limits, for loans?
  - c. Establishes suggested guidelines for aggregate outstanding loans in relation to other balance sheet categories?
  - d. Establishes loan authorities of committees and individual lending officers?
  - e. Defines acceptable types of loans?
  - f. Establishes maximum maturities for various types of loans?
  - g. Establishes loan pricing?
  - h. Establishes appraisal policy?
  - i. Establishes minimum financial information required at the inception of the credit?
  - j. Establishes limits and guidelines for purchasing loans?
  - k. Establishes collection procedures?
    - l. Defines the duties and responsibilities of loan officers and loan committees?
  - m. Outlines loan portfolio management objectives that acknowledge the need to employ personnel with specialized knowledge and experience?
2. Are the following reported to the head office at least monthly:
  - a. Past due loans?
  - b. Loans on nonaccrual?
  - c. Classified loans?
  - d. Loans requiring special attention?
  - e. New loans, loan renewals, and restructured loans?
3. Are reports checked by a designated individual for possible omissions before they are submitted to the head office?
4. Are written applications required for all loans?
5. Do credit files contain the following information:

### GENERAL INFORMATION

- The borrower's name, address, ownership, and affiliations?
- A description of the borrower's business?
- Amount, rate and maturity of the loan; type of loan; appropriate approvals?
- The purpose of the loan?
- The primary and secondary sources of repayment?
- The planned repayment schedule?
- The disposition of the loan proceeds?

### FINANCIAL INFORMATION

- Current financial information on the borrower and guarantor (if applicable)?
  - Three years of previous financial statements?
  - An analysis of the borrower's and guarantor's (if applicable) financial condition?
  - Projections for the borrower's future financial performance?
  - A description of the collateral, its location, value, and condition?
  - Covenant compliance checksheet, if applicable.
6. Does the branch perform a credit investigation on proposed and existing borrowers for new loan applications?
  7. Is it required that all loan commitments be in writing?
  8. Are lines of credit reviewed and updated at least annually?
  9. Are borrowers' outstanding liabilities checked to appropriate lines of credit before additional advances are granted?
  10. Does the branch employ a procedure for disclosure of a loan or combination of loans that are or will be secured by 25 percent of another insured financial institution's stock?
  11. Is there an internal review system that:
    - a. Rechecks interest, discount, and maturity date computations?
    - b. Reexamines notes for proper execution, receipt of all required supporting papers, and proper disclosure forms?

- c. Determines that loan approvals are within the limits of the branch's lending authorities?
- d. Determines that notes bear the initial of the loan officer?
- e. Ascertains that new loans are within the limitations set for the borrower by corporate resolution?
- f. Rechecks the liability ledger to determine that new loans have been accurately posted?

Loan transfers, purchases and sales involving other U.S. branches and affiliates of the FBO are evaluated to determine whether branch management retains responsibility for the loan. In such a case, the management of the transferred loans will be considered in assessing risk management at the branch. Loan transfers are also evaluated to determine whether they were transferred to avoid classification and to determine any effect of the transfer on the institution's condition. In cases where the transfer is suspected of being improper, the appropriate regulatory authorities for the other financial institution involved in the transfer should be notified.

- 12. Review loan transfers for the following:
  - a. Determine that the branch does not buy back or pay interest on defaulted loans in contravention of the underlying loan agreement.
  - b. Compare the volume of loans purchased and sold to the total portfolio.
  - c. Determine that the branch has sufficient expertise to properly evaluate the volume of loans purchased and sold.
  - d. Determine if loans are sold primarily to accommodate overline needs of customers or to generate fee income.
  - e. Investigate any situations where assets were transferred before the date of the examination to determine if any were transferred to avoid possible criticism during the examination.
  - f. Determine whether any of the loans transferred were nonperforming at the time of transfer, classified at the previous exami-

- nation, or were considered to be of questionable quality for any other reason.
- g. Review the branch's policies and procedures to determine whether or not assets or participations purchased by the branch are given an independent, complete, and adequate credit evaluation.
- h. Determine that assets purchased by the branch are properly reflected on its books at fair market value.

While fair market value may be difficult to determine, it should, at a minimum, reflect both the rate of return being earned on such assets and an appropriate risk premium. Determine that appropriate write-offs are taken on any assets sold by the branch at less than book value.

- 13. Is a systematic and progressively stronger follow-up notice procedure utilized for delinquent loans?
- 14. Has the branch conducted industry studies for those industries in which it is a substantial lender?
- 15. Are loan proceeds ever disbursed in cash? If so, notify BSA examiner.
- 16. Are loans ever paid off by liquidating cash collateral? If so, notify BSA examiner.
- 17. Are adequate accounting and control procedures in effect with respect to recoveries?
- 18. Are adequate procedures in effect to monitor compliance with the lending limits?
- 19. Are original loan documents safeguarded properly?
- 20. Are notes and collateral periodically verified by an independent party?

## CONCLUSION

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

# Credit Risk Management

## Audit Guidelines

Effective date July 1997

## Section 3010.5

1. Test the additions of the trial balances and the reconciliation of the trial balances to the general ledger. Include loan commitments and other contingent liabilities.
2. Using an appropriate sampling technique, select loans from the trial balance and perform the following:
  - a. Prepare and mail confirmation forms to borrowers. Loans serviced by other institutions, either whole loans or participations, should be confirmed only with the servicing institution. Confirmation forms should include borrower's name, loan number, the original amount, interest rate, current loan balance, contingency and escrow account balance, and a brief description of the collateral.
  - b. After a reasonable time, mail second requests.
  - c. Follow up on any no-replies or exceptions, and resolve differences.
  - d. Examine notes for completeness and verify date, amount, and terms to trial balance.
  - e. In the event any notes are not held at the branch, request confirmation by the holder.
  - f. Check to see that the note is signed, appears to be genuine, and is negotiable.
  - g. Check to see that the required initials of the approving officer are on the note.
  - h. Determine that the amount is within the officer's lending limit.
  - i. Compare collateral held in files with the description on the collateral register.
  - j. Determine that the proper assignments, stock powers, hypothecation agreements, statements of purpose, etc., are on file.
  - k. Test the pricing of the negotiable collateral.
  - l. Determine that margins are reasonable and are in line with branch policy and legal requirements.
  - m. Determine if any collateral is held by an outside custodian or has been temporarily removed for any reason.
  - n. Forward a confirmation request on any collateral held outside the branch.
  - o. For accounts receivable financing, reconcile accounts receivable invoices to collateral records.
  - p. For banker's acceptances, compare collateral (e.g. trust receipts and warehouse receipts) with the description on the collateral records. Check to be sure that procedures are in effect to preclude a customer from obtaining additional credit extensions on the same merchandise.
  - q. Review escrow account provisions to determine if undisbursed amounts are at least equal to the provisions in the escrow agreements. Determine if debit entries to escrow accounts are authorized according to the terms of the loan agreement and if they are supported by individual bills or other evidence.
  - r. List all discrepancies and investigate.
  - s. Determine that each file has documentation supporting guarantees and subordination agreements, where appropriate.
  - t. Determine that any necessary insurance coverage is adequate and that the branch is named as loss payee.
  - u. Review participation agreements, making excerpts where necessary for such items as rate of service fee, interest rate, retention of late charges, and remittance requirements, and determine whether participant has complied.
  - v. Review disbursement ledgers and authorizations and determine if authorizations are signed in accordance with the terms of the loan agreement.
3. Review the accrued interest accounts by:
  - a. Reviewing and testing procedures for accounting for accrued interest and for handling of adjustments.
  - b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing to initial and supporting records.
  - c. For those loans selected in step 2, independently calculate the amount of accrued interest and verify the amount to the detail of accrued interest receivable for that loan.
4. Using a list of nonaccruing loans, check loan accrual records to determine if interest income is not being recorded.

5. Obtain or prepare a schedule showing the monthly interest income amounts and the accounts receivable loan balance at each month-end since the last audit and:
  - a. Calculate yield.
  - b. Investigate significant fluctuations and/or trends.
6. Test accuracy and completeness of all management reports.

Asset-based lending is a specialized area of commercial 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 branch, 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 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 branch's internal controls, policies, practices, and procedures.

### CHARACTERISTICS OF THE BORROWER

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial loans may use asset-based loans to meet their financial needs. Typical characteristics of asset-based borrowers are those which:

- Are growing rapidly and need year-round financing in amounts too large to justify unsecured credit or commercial lines of credit secured by blanket liens on accounts receivable and inventory;
- Are nonseasonal and need year-round financing because working capital and profits are insufficient to permit periodic clean-ups;
- Have inadequate working capital for the volume of sales and type of operation; and,
- Cannot obtain regular commercial loan terms because of deteriorating credit factors.

### ADVANTAGES TO THE BORROWER AND THE BRANCH

From the borrower's viewpoint, asset-based lending:

- Provides an efficient way to finance an expanding operation because borrowing capacity expands as sales increase;
- Permits the borrower to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis, thereby building a strong business relationship and reducing the cost of goods sold;
- Ensures a revolving, expanding line of credit for which the actual interest paid may be less than that for a fixed amount unsecured loan.

From the branch's viewpoint, asset-based lending:

- Generates a relatively high yield loan commensurate with the perceived credit risk of the borrower;
- Generates a depository relationship which provides income and enhances the branch's ability to monitor changes in the borrower's cash flow and overall financial condition;
- Permits a continuing branch relationship with longstanding customers whose financial condition no longer warrant unsecured credit or traditional commercial lines of credit; and,
- Minimizes potential loss when the loan is collateralized by a percentage of the accounts receivable and inventory.

However, as discussed further, this type of lending requires close and periodic supervision of the borrower's financial condition and regular monitoring of the borrower's accounts receivables to ensure compliance with the financing agreement.

### CREDIT AND COLLATERAL 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 must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort. The borrower's financial statements should be analyzed with particular emphasis on working capital and its trends. Trade reports should be

reviewed, the agings of receivables and payables should be scrutinized, and inventory turnover should be analyzed. Furthermore, the prompt payment of taxes, especially payroll taxes, should be verified. A primary 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. If it is not doing so, it may be diverting the funds out of the business and/or the company's financial condition may not warrant this type of financing.

Branch 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. The line theoretically could be fully liquidated by discontinuing further advances, collecting the assigned receivables and liquidating pledged inventory. However, such drastic action could cause the borrower's business to close resulting in a probable deterioration of the receivables from new disputes and in returns and offsets. So that the branch's loan may be liquidated in an orderly manner without losses or other adverse effects, the branch usually notifies its borrower of a contemplated liquidation, allowing the borrower time to seek other means of continuing the business. Asset-based lines where the financial position has declined so that refinancing is prevented should be criticized, unless the branch has initiated an orderly liquidation. When such a liquidation is occurring, the examiner may not see the need for classification if the borrower's business is continuing, the existing collateral is of good quality, and no collateral deterioration is anticipated.

In asset-based lending, branch management should continually evaluate the realizable value of assets pledged. To do so, management should review the loan agreement and compliance therewith; the quality of the assets pledged, including documentation; and the safeguards to ensure the authenticity and collectibility of the pledged assets. The information obtained is sometimes difficult to interpret unless it is related to other periods, comparable businesses, or industry statistics. The following factors should be considered in evaluating the quality of assets pledged:

*The turnover of the receivables pledged and the borrower's credit limit.* If the turnover is

decreasing, the quality of receivables may be deteriorating.

*Aging of accounts receivable.* The branch should obtain a monthly aging of the accounts receivable pledged. The examiner should note the percentage of accounts delinquent in relation to the total accounts pledged, and those accounts having past due balances, which also have current amounts due.

*Concentration of debtor 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. A list of concentrations should be prepared periodically showing the largest accounts.

*Ineligible receivables.* The examiner should be aware of receivables that, by their nature, should be excluded from the lending formula. The following are examples of receivables that may be considered ineligible:

- *Due from affiliated companies.* Although such receivables might be valid, the temptation for the borrower to create fraudulent invoices would be great.
- *Receivables subject to a purchase money interest, such as floor plan arrangements.* The 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 where rights to the receivables are subordinated to the branch.

*Financial strength of debtor accounts.* The branch should maintain credit information and trade reports on large debtor accounts as part of the borrower's credit file. The examiner should determine whether the debtor accounts are significant to the borrower's business and are well rated and financially strong.

*Disputes, returns, and offsets.* The borrower should furnish promptly to the branch copies of all significant credit memoranda issued. An analysis of those memoranda must be made. A large or increasing volume of such transactions could adversely affect the branch's collateral position.

## DOCUMENTATION

*Loan Agreement*—An asset-based loan agreement is a contract between a borrower and the branch that sets forth conditions governing the handling of the account and the remedies available in the event of default. Among the major provisions, might be:

- A percentage advance against acceptable receivables. The advance may depend on the gross profit margin from the sale of merchandise and the credit quality of the borrower's customers. For example, if a borrower has a gross profit margin of 30 percent, the maximum advance might be 70 percent, with a reduced percentage if the borrower's customers do not have top credit ratings.
- Use of only acceptable receivables. This term refers to a branch's outlining qualifications for acceptance. For example, acceptable receivables may include only those accounts that are current or not more than a given number of days past due. The entire amount of receivables may be unacceptable if a certain percentage, e.g., 10 percent, is 90 days or more delinquent.
- A maximum dollar amount due from any one account debtor. Because there is always the possibility of unforeseen and undisclosed credit failure or a return of merchandise, a common benchmark is that no more than 20 percent of the receivables assigned are from one customer.

*Documentation of Advances*—There are two dominant methods by which advances are made. Under the *blanket assignment* method, the borrower periodically supplies the branch with documentation of the amount of receivables outstanding on its books. Based upon this information, the branch advances the agreed percentage of the outstanding receivables. The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower, who then remits them to the branch. The branch applies all or a portion of such funds to the borrower's loan and/or the cash collateral account, which is under the branch's control. Under the *ledgery of accounts* method, the lender receives duplicate copies of the invoices together with the shipping documents and/or delivery receipts. Upon receipt of satisfactory information, the branch advances

the agreed percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. Under this method, the branch maintains complete control of all funds paid on all accounts pledged by requiring the borrower's customer(s) to remit directly to the branch. The same application of payments is then used as under the blanket assignment method. Regardless of the methods used, the branch should ensure its collateral through a program of regular audit and direct confirmation.

*Security Agreement and Financing Statement*—Article 9 of the Uniform Commercial Code (UCC) applies to any transaction that is intended to create a security interest in accounts receivable. Under the UCC, the branch must create a valid and enforceable security interest and *perfect* that interest. Once an enforceable security interest is created, the secured party can always enforce it, on default, against the debtor, provided there is no superior third-party interest. If the holder of a valid and enforceable Article 9 interest takes the additional steps required to perfect under Article 9, it will defeat most such third parties.

Under the provisions of the UCC, a branch should request from the Secretary of State, or other filing office, a listing of any open liens on the customer's receivables or inventory. Providing no such liens are outstanding, the branch should then obtain a Security Agreement, Accounts Receivable and a Financing Statement and file promptly. The security agreement and financing statement should cover current and future accounts and advances for all proceeds thereof (a "blanket assignment"), or detail the specific item(s) being taken as collateral (a "specific assignment"). To protect its rights to the receivables, the lending branch should consider taking a lien on the borrower's current and future inventory and all proceeds thereof.

Sections 9-203 and 9-204 of the UCC require that the parties take four steps to create a valid and enforceable security interest. They must:

- Enter into a security agreement.
- Reduce as much of that agreement to writing as is necessary to satisfy Section 9-203, which also requires that the debtor sign this writing or give possession of the collateral to the creditor.
- Have the debtor acquire rights in the collateral.
- Have the secured party give value.

Section 9-302(10) provides for automatic perfection, without filing a financing statement, when any or all assignments to the branch do not transfer a significant part of the outstanding accounts of the borrower. However, in all other accounts receivable security interests, the branch must file a financing statement to perfect its security interest. The law of the jurisdiction in which the debtor is located provides where the financing statement must be filed. Filing location is determined by place of business, executive office, or residence if the debtor has no place of business in the state. Refer to the appropriate State jurisdiction for filing instructions.

The financing statement, which is the document filed for public notice, must:

- Give the names and mailing addresses of the debtor and secured party.
- Be signed by the debtor.
- Give an address of the secured party from which information concerning the security interest may be obtained.
- Give the mailing addresses of the debtor and the secured party.
- Contain a statement indicating the types of collateral or describing the items or collateral.
- Be renewed every five years.

A copy of the security agreement is sufficient as a financing statement if it meets the preceding requirements.

Although effective compliance with the UCC creates, in most instances, a valid and enforceable first lien, it does not insulate the branch from the need to police its collateral. By filing, the branch establishes the right to collect on only those receivables assigned to it, provided:

- The sales are legitimate.
- The merchandise has been delivered.
- The merchandise is as ordered.
- Sales were made without warranties (almost all sales are covered by warranties).
- The merchandise was not shipped on consignment.
- The merchandise is not subject to offset, i.e., contra accounts or liens.
- The receivable has not already been paid to the borrower.

## ENSURING AUTHENTICITY AND COLLECTIBILITY

Regardless of the advance methods used, the following safeguards, which branch management should consider and the examiner should evaluate, ensure the authenticity and collectibility of the pledged assets:

*Audits.* To verify the information supplied by the borrower to the branch, the branch sends its staff member(s) to the borrower's place of business to audit its books. The audit should occur several times a year, usually on a quarterly basis. The scope of such audit should include preparation of balance sheets, profit and loss statements, working capital analysis, agings of payables and receivables, an inspection of inventory and related records, and a determination that the debtor accounts are properly marked on the books as assigned to the branch. The audit also should include procedures to determine whether all significant credit memoranda have been properly issued and reported by the borrower to the branch.

*Confirmations.* To verify the authenticity of the pledged collateral, the branch should institute a program of direct confirmation. This procedure is particularly important if the accounts receivable are pledged on a non-notification basis because the branch does not have the same control of the debtor accounts as it does when the receivables are pledged on a notification basis. Direct confirmations should be made before the initial lending arrangement and, thereafter, at least semiannually. Confirmations should be on a positive basis. The branch should obtain written approval from the borrower before confirming accounts receivable on a non-notification basis. Further, the branch should consider using the name of a phantom company as sender of the confirmations and having the confirmations returned to a post office box to ensure that account debtors do not know that their receivables are being pledged.

# Asset-Based Lending

## Examination Objectives

Effective date July 1997

## Section 3020.2

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1. To determine if the policies, practices, procedures, and internal controls regarding asset-based lending are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for collateral sufficiency, credit quality, and collectibility.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws or regulations have been noted.

# Asset-Based Lending

## Examination Procedures

Effective date July 1997

## Section 3020.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of asset-based lending activities. However, if the branch engages in significant asset-based lending activities, and additional information is needed, the examiner should perform the following examination procedures.

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
3. Review the following information for selected asset-based loans:
  - a. Relationship between amount collected in a month on the receivables pledged as collateral and the borrower's credit limit.
  - b. Aging of accounts receivable.
  - c. Ineligible receivables.
  - d. Concentration of debtor accounts.
  - e. Financial strength of debtor accounts.
  - f. Disputes, returns, and offsets.
  - g. Management's safeguards to ensure the authenticity and collectibility of the assigned receivables.
4. Analyze secondary support offered by guarantors and endorsers.
5. Ascertain compliance with established branch policy.
6. Discuss with appropriate officer(s) and prepare a summary of the branch's asset-based lending activities.
7. Evaluate the function with respect to:
  - a. The adequacy of written policies relating to asset-based lending.
  - b. The manner in which branch officers are conforming with established policy.
  - c. Adverse trends within the asset-based lending department.
  - d. Accuracy and completeness of the management reports relating to asset-based lending obtained from the branch.
  - e. Internal control deficiencies or exceptions.
  - f. Recommended corrective action when policies, practices, or procedures are deficient.
  - g. The competency of departmental management.
  - h. Other matters of significance.
8. Update the workpapers with any information that will facilitate future examinations.

# Asset-Based Lending Internal Control Questionnaire

Effective date July 1997

## Section 3020.4

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Refer to the Credit Risk Management internal control questionnaire for a general review of the branch's internal controls, policies, practices, and procedures. If the branch engages in significant asset-based lending activities, and additional information is needed, the examiner should complete the following internal control questionnaire. For audit procedures, refer to the Credit Risk Management section 3010.5.

1. Does the branch have policies specifically relating to asset-based lending that:
  - a. Establish procedures for reviewing asset-based lending applications?
  - b. Establish standards for determining credit lines?
  - c. Establish standards for determining the percentage advance to be made against acceptable receivables?
  - d. Define acceptable receivables?
  - e. Establish minimum requirements for verification of borrower's pledged assets?
  - f. Establish minimum standards for documentation?
2. Are policies reviewed at least annually to determine if they are compatible with changing market conditions?

3. Does the branch record on a timely basis a first lien on the assigned receivables for each borrower?
4. Do all loans granted on the security of the receivables also have an assignment of the inventory?
5. Does the branch verify the borrower's accounts receivable or require independent verification on a periodic basis?
6. Does the branch require the borrower to provide aged accounts receivable schedules on a periodic basis?

### CONCLUSION

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

Banking organizations, including branches, have long been involved with asset-backed securities (ABS), both as investors in such securities and as major participants in the securitization process. In recent years, they have stepped up their involvement by increasing their participation in the long-established market for securities backed by residential mortgage loans. Banking organizations have also expanded their securitization activities to include other types of assets, such as credit card receivables, automobile loans, boat loans, commercial real estate loans, student loans, nonperforming loans, and lease receivables.

### AN OVERVIEW OF ASSET SECURITIZATION

In recent years, the number of banking organizations that have issued securities backed by their own assets and that have acquired ABS as investments has increased markedly. This increase has resulted because securitization activities can yield significant financial and operational benefits.

In its simplest form, asset securitization involves the selling of assets. The process first segregates generally illiquid assets into pools and transforms them into capital market instruments. The payment of principal and interest on these instruments depends on the cash flows from the assets in the pool underlying the new securities. The new securities may have denominations, cash flows, and other features that differ from the pooled assets making the securities in them more attractive to investors.

The federal government encourages the securitization of residential mortgages. In 1970, the Government National Mortgage Association (GNMA) created the first publicly traded mortgage-backed security. Soon, the Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC), both government-sponsored agencies, also developed mortgage-backed securities. The guarantees provided by these government or government-sponsored entities assure investors of the payment of principal and interest and have thus greatly facilitated the securitization of mortgage assets. As previously mentioned, securities have also been issued that are backed by other assets such as: credit card receivables, automobile loans, boat loans, com-

mercial real estate loans, home equity loans, student loans, nonperforming loans, and lease receivables.

### BENEFITS AND RISKS OF ASSET SECURITIZATION

While the objectives of securitization may vary from organization to organization, there are essentially five benefits that can be derived from securitized transactions. First, the sale of assets may reduce regulatory costs. The removal of an asset from an FBO's books generally reduces capital requirements and reserve requirements on the deposits funding the asset. Second, asset securitization provides originators with an additional source of funding or liquidity or both. The process of securitization basically converts an illiquid asset into a security with greater marketability. Securitized issues often require a credit enhancement, which results in a higher credit rating than what would normally be obtainable by the institution itself. Consequently, these issues may provide a cheaper form of funding to the banking organization. Third, securitization may be used to reduce interest-rate risk by improving the organization's asset-liability mix. Such a benefit is more likely if the organization has a large investment in fixed-rate, low-yield assets. Fourth, by removing assets, the organization enhances its return on equity and assets. Finally, the ability to sell these securities worldwide diversifies the organization's funding base which reduces the dependence of the branch on local economies.

It may be appropriate for a banking organization, including a branch, to engage in securitization activities and to invest in ABS, if it does so in a prudent manner. Nonetheless, these activities can significantly affect a branch's overall risk exposure. It is of great importance, particularly given the growth and expansion of such activities, that examiners be fully informed of the fundamentals of the securitization process, including knowledge of the various risks that securitization and investing in ABS create for branches. Additionally, examiners need to be aware of the pertinent examination procedures in order to effectively assess the branch's exposure to risk and its ability to manage that exposure.

The following instructions were developed for Federal Reserve System use in order to provide examiners with the information and guidance they need on asset securitization. These instructions discuss the mechanics of securitization and related accounting issues while also providing a set of examination guidelines, objectives, and procedures.<sup>1</sup> The various state and federal agencies may differ in terms of specific practices and methodologies used to implement these guidelines. For further guidance in this area, examiners should consult with their respective agencies.

## THE SECURITIZATION PROCESS

The asset securitization process begins with the segregation of loans or leases into pools that are relatively homogeneous with 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 it issues the securities or ownership interests that are acquired by investors. These asset-backed securities may take the form of debt, certificates of beneficial ownership, or other instruments. The issuer is typically protected from bankruptcy by various structural and legal arrangements. A sponsor that provides the assets to be securitized owns or otherwise establishes the issuer.

Each issue of ABS has a servicer that is responsible for collecting interest and principal payments on the loans or leases in the underlying pool of assets and for transmitting these funds to investors (or a trustee representing them). A trustee is responsible for monitoring the activities of the servicer to ensure that it properly fulfills its role.

A guarantor may also be involved to ensure that principal and interest payments will be received by investors on a timely basis, even if the servicer does not collect these payments from the obligors. Many issues of mortgage-backed securities are guaranteed directly by GNMA, a government agency backed by the full faith and credit of the U.S. government, or by FNMA or FHLMC, both government-

1. The Federal Reserve System has developed a three-volume set that contains educational material concerning the process of asset securitization and examination guidelines. The volumes are as follows: (a) An Introduction to Asset Securitization, (b) Accounting Issues Relating to Asset Securitization, and (c) Examination Guidelines for Asset Securitization.

sponsored agencies that are perceived by the credit markets to have the implicit support of the federal government. Privately issued, mortgage-backed securities and other types of asset-backed securities generally depend on some form of credit enhancement provided by the originator or third party to insulate the investor from a portion of or all credit losses. Usually, the amount of the credit enhancement is based upon several multiples of the historical losses experienced on the particular asset backing the security.

## Credit Enhancement

One form of credit enhancement is the recourse provision, or guarantee, that requires the originator to cover any losses up to an amount contractually agreed upon. Some asset-backed securities, such as those backed by credit card receivables, typically use a spread account. This account is actually an escrow account. The funds in this account are derived from a portion of the spread between the interest earned on the assets in the underlying pool and the lower interest paid on securities issued by the trust. The amounts that accumulate in the account are used to cover credit losses in the underlying asset pool up to several multiples of historical losses on the particular asset collateralizing the securities.

Overcollateralization, another form of credit enhancement covering a predetermined amount of potential credit losses, occurs when the value of the underlying assets exceeds the face value of the securities. A third form of credit enhancement involves the use of the senior-subordinated security structure. Under such a structure, at least two classes of asset-backed securities are issued, with the senior class having a priority claim on the cash flows from the underlying pool of assets. Therefore, the subordinated class must absorb credit losses before they can be charged to the senior portion. Because the senior class has this priority claim, cash flows from the underlying pool of assets must first satisfy the requirements of the senior class. Only after these requirements have been met will the cash flows be directed to service the subordinated class.

A more recent form of credit enhancement is the cash collateral account, which is established when a third party deposits cash into a pledged account. The use of cash collateral accounts

grew as the number of highly rated banks and other credit enhancers declined in the early 1990s. Other forms of credit enhancement include standby letters of credit, pool insurance, or surety bonds from third parties.

An investment banking firm or other organization generally serves as an underwriter for ABS. In addition, for asset-backed issues that are publicly offered, a credit rating agency will analyze the policies and operations of the originator and servicer as well as the structure, underlying pool of assets, expected cash flows, and other attributes of such securities. Before assigning a rating to the issue, the rating agency will also assess the extent of loss protection provided to investors by the credit enhancements associated with the issue.

Traditional lending activities are generally funded by deposits or other liabilities with both the assets and related liabilities reflected on the balance sheet. Liabilities must generally increase in order to fund additional loans. In contrast, the securitization process generally does not increase on-balance-sheet liabilities in proportion to the volume of loans or other assets securitized. As discussed more fully below, when banking organizations securitize their assets and these transactions are treated as sales, both the assets and the related ABS (i.e., liabilities) are removed from the balance sheet. The cash proceeds from the securitization transactions are generally used to originate or acquire additional loans or other assets for securitization and the process is repeated. Thus, for the same volume of loan originations, securitization results in lower assets and liabilities in comparison to traditional lending activities.

## The Structure Of Different Types Of ABS

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 basis. This type of security may be a single-class instrument such as a GNMA pass-through or a multi-class instrument such as a real estate mortgage investment conduit (REMIC).<sup>2</sup>

2. In the early 1980s, collateralized mortgage obligations

The pay-through structure with multiple classes combines 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. An example 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 collateral go first to the earliest maturing class of bonds. This first class of bonds must be retired before the principal cash flows are 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.

Multiple-class, ABS may also be issued as derivative instruments, such as stripped securities. Investors in each class of a stripped security will 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 (IO) strips, for which the investor receives 100 percent of the interest from the underlying pool of assets and as principal-only (PO) strips, for which the investor receives all of the principal.

In addition to these securities, other types of financial instruments may arise as a result of asset securitization, as follows:

- *Loan servicing rights*—these instruments are created when organizations purchase or originate loans, sell or securitize the loans, and retain the right to act as servicers for pools of loans. The cost of these purchased servicing rights may be recorded as an intangible asset when certain criteria are met. In addition, servicing rights are created when organizations

(CMOs), or multiple class securities, were introduced to help minimize the reinvestment and interest rate risks inherent in the traditional fixed rate mortgage-backed security. As a result of the Tax Reform Act of 1986, REMIC was created. The REMIC is a more flexible mortgage security, which expanded the appeal of the CMO structure to a wider investor base and offered preferred tax status to both investors and issuers. Today, almost all CMOs are issued in REMIC form. (From The ABCs of CMOs, REMICs and IO/POs: Rocket Science Comes to Mortgage Finance, Journal of Accountancy, April 1991, p. 41.)

purchase the right to act as servicers for loan pools.

- *Excess servicing fee receivables* —These instruments generally arise when the present value of any additional cash flows from the underlying assets that a servicer expects to receive exceeds standard servicing fees.
- *ABS residuals (sometimes referred to as residuals or residual interests)*—They represent claims on any cash flows that remain after all obligations to investors and any related expenses have been met. Such excess cash flows may arise as a result of overcollateralization or from reinvestment income. Residuals can be retained by sponsors or purchased by investors in the form of securities.

## SUPERVISORY CONSIDERATIONS

Clear benefits can accrue to banking organizations that engage in securitization activities and invest in ABS. Nonetheless, securitization activities can increase the overall risk profile of the banking organization if the activities are not carried out in a prudent manner. For the most part, the types of risks that financial institutions encounter in the securitization process are identical to those that they face in traditional lending transactions. These involve credit risk, concentration risk, interest-rate risk, including prepayment risk, operational risk, liquidity risk, moral recourse risk, and funding risk. However, because the securitization process separates the traditional lending function into several limited roles such as originator, servicer, credit enhancer, trustee, and investor, the types of risks that a branch will encounter will differ depending on the role it assumes.

As with direct investments in the underlying assets, investors in ABS will be exposed to credit risk, that is, the risk that obligors will default on principal and interest payments. Investors are also subject to the risk that the various parties, for example, the servicer or trustee, in the securitization structure will be unable to fulfill their contractual obligations. Moreover, investors may be susceptible to concentrations of risks across various ABS issues through over-exposure to an organization performing various roles in the securitization process, or as a result of geographic concentrations within the pool of assets providing the cash flows for an individual issue. Also, because the

secondary markets for certain ABS are thin, investors may encounter greater than anticipated difficulties when seeking to sell their securities. Furthermore, certain derivative instruments, such as stripped ABS and residuals, may be extremely sensitive to interest rates and exhibit a high degree of price volatility, and, therefore, may dramatically affect the risk exposure of investors, unless used in a properly structured hedging strategy.

## Issuer

Banking organizations that issue ABS may be subject to pressures to sell only their best assets, thus reducing the quality of their own loan portfolios. On the other hand, some organizations may feel pressures to relax their credit standards because they can sell assets with higher risk than they would normally want to retain for their own portfolios.

To protect their names in the market, issuers may feel pressures to provide moral recourse by repurchasing securities backed by loans or leases that they originated and which have since deteriorated and become nonperforming. Funding risk may also be a problem for issuers when market aberrations do not permit the issuance of ABS that are in the securitization pipeline.

## Servicer

Banking organizations that service securitization issues must ensure that their policies, operations, and systems will not permit breakdowns that may lead to defaults. Substantial fee income can be realized by acting as servicer. An institution already has a fixed investment in its servicing systems, and achieving economies of scale relating to that investment is in its best interest. The danger, though, lies in overloading the systems' capacity, thereby creating enormous out-of-balance positions and cost overruns. Servicing problems may potentially precipitate a technical default, which, in turn, could lead to the premature redemption of the security. In addition, expected collection costs could exceed fee income. (For further guidance, refer to the Federal Reserve's *Commercial Bank Examination Manual*, Loan Portfolio Management section.)

## Accounting Issues

Asset securitization transactions are frequently structured to obtain certain accounting treatments, which, in turn, affect 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, that is, a financing transaction secured by assets. Sales treatment results in the assets being removed from the branch's balance sheet, thus reducing total assets relative to earnings and capital and, thereby, producing higher performance and capital ratios. Treatment of these transactions as financings, however, means that the assets in the pool remain on the balance sheet and the related liabilities are subject to reserve requirements.<sup>3</sup>

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3. Note, however, that it is the Federal Reserve's Regulation D that defines what constitutes a reservable liability of a depository institution. Thus, although a given transaction may qualify as an asset sale for regulatory reporting purposes, it nevertheless could result in a reservable liability under Regulation D.

## Securitization Of Commercial Paper

Over time, banking institutions have increasingly been involved in the securitization of commercial paper. It is important to note, however, that asset-backed commercial paper programs differ from other methods of securitization. One difference is that more than one type of asset may be included in the receivables pool. Moreover, in certain cases, the cash flow from the receivables pool may not necessarily match the payments to investors because the maturity of the underlying asset pool does not always parallel the maturity of the structure of the commercial paper. Consequently, when the paper matures, it is usually rolled over or funded by another issue. In certain circumstances, a maturing issue of commercial paper cannot be rolled over. To address this problem, many banking institutions have established back-up liquidity facilities. Certain banking institutions have classified these back-up facilities as pure liquidity facilities despite the credit-enhancement element present in such facilities and, as a result, have incorrectly assessed the risks associated with such back-up liquidity facilities. In these cases, the back-up liquidity facilities have been more similar to direct credit substitutes than to loan commitments.

# Asset Securitization

## Examination Objectives

Effective date July 1997

## Section 3030.2

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1. To determine if the branch is in compliance with laws, regulations and policy statements.
2. To determine if the branch is involved in originating, servicing, providing credit enhancements, serving as a trustee for, or investing in securitized assets.
3. To determine that securitization activities are properly managed within the context of the branch's overall risk management techniques.
4. To determine that management has an appropriate level of experience in securitization activities.
5. To ensure that the branch does not hold any asset-backed securities that are inappropriate, given the size of the branch and the sophistication of its operations, e.g., IOs and POs.
6. To ensure that all asset-backed securities owned and any assets sold with recourse are properly accounted for on the branch's books and in the branch's regulatory reports.
7. To determine that sources of credit risk are understood and properly analyzed and managed without excessive reliance on credit ratings by outside agencies.
8. To determine that credit, operational, and other risks are recognized and are addressed through appropriate policies, procedures, management reports, and other controls.
9. To determine if officers are operating in conformance with established branch policies and procedures.
10. To determine that liquidity and market risks are recognized and the branch is not excessively dependent on securitization as a substitute for funding or as a source of income.
11. To determine that steps have been taken to minimize the potential for conflicts of interest due to securitization.
12. To determine that possible sources of structural failure in securitization transactions are recognized, and that branch and head office management has adopted measures to minimize the impact of such failures should they occur.
13. To determine that branch and head office management is aware of the legal risks and uncertainty regarding various aspects of securitization.
14. To determine that concentrations of exposure in the underlying asset pools, in the asset-backed securities portfolio, or in the structural elements of securitization transactions are avoided.
15. To determine that all sources of risk are evaluated at the inception of each securitization activity and are monitored on an ongoing basis.
16. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of laws, regulations or policy statements have been noted.

# Asset Securitization Examination Procedures

Effective date July 1997

## Section 3030.3

These procedures represent a comprehensive list of processes and activities to be reviewed during a full scope examination. The examiner-in-charge will establish the general scope of the examination and work with the examination staff to tailor specific areas for review as circumstances warrant. The procedures selected will be based on internal audit comments, previous examination workpapers, a general review of the activity to be examined, and the judgement of the examiner and examiner-in-charge.

1. Request a schedule of all asset-backed securities owned by the branch. Reconcile to subsidiary ledgers of the balance sheet and review credit ratings assigned to these securities by independent rating agencies. Determine that the accounting methods and procedures used for these assets, at inception and throughout the carrying life, are appropriate.
2. Request and review information on the types and amount of assets that have been securitized by the branch. In addition, request information concerning potential contractual or contingent liability from guarantors, underwriting, and servicing of securitized assets, whether originally securitized by the branch or not.
3. Review the branch's policies and procedures to ensure that it follows prudent standards of credit assessment and approval for all securitization exposure. Procedures should include thorough and independent credit assessment of each loan or pool for which it has assumed credit risk followed by periodic credit reviews to monitor performance throughout the life of the exposure. If a branch invests in asset-backed securities, determine whether there is sole reliance upon the conclusions of external rating services when evaluating the securities.
4. Determine that rigorous credit standards are applied regardless of the role the branch plays in the securitization process, for example, servicer, credit enhancer, or investor.
5. Determine that major policies and procedures, including internal credit review and approval procedures and in-house exposure limits, are reviewed periodically and approved by head office management.
6. Determine whether adequate procedures for evaluating the branch's internal control procedures and financial strength of the other institutions involved in the securitization process are in place.
7. Obtain the documentation outlining any credit enhancements and the remedies available in the event of a default. In addition, both originators and purchasers of securitized assets should have a prospectus on the issue. Obtaining a copy of the prospectus can be an invaluable source of information; a prospectus generally should contain information on credit enhancement, default provisions, subordination agreements, etc. In addition to the prospectus, obtain the documentation confirming the purchase or sale of a security.
8. Ensure that, regardless of the role a branch plays in the securitization process, the documentation for an asset-backed security clearly specifies the limitations of the branch's legal responsibility to assume losses.
9. Verify whether the branch, acting as originator, packager, or underwriter, has written policies addressing the repurchase of assets and other reimbursement to investors in the event that a defaulted package results in losses exceeding any contractual credit enhancement. The repurchase of defaulted assets or pools, although not required by the underlying agreement, in effect sets a standard by which a branch could potentially be found legally liable for all sold assets. Review and report any situations in which the branch has repurchased or otherwise reimbursed investors for poor quality assets.
10. Evaluate credit risk of asset-backed securities and classify any adverse credit risk. List classified assets and evaluate the impact of the classifications on the overall evaluation of the branch.
11. Aggregate securitization exposures with all loans, extensions of credit, debt and equity securities, legally binding financial guarantees and commitments, and any other investments involving the same obligor when determining compliance with internal credit exposure limits.

12. Review the branch's valuation methodology for asset-backed securities to determine if it is appropriate.
13. Review securitized assets for industrial or geographic concentrations. Excessive exposures to an industry or region among the underlying assets should be noted in the review of the loan portfolio and evaluated in the context of the risk management assessment.
14. Ensure that, in addition to policies limiting direct credit exposure, a branch has developed exposure limits with respect to particular originators, credit enhancers, trustees, and servicers.
15. Review the policies of a branch engaged in underwriting with regard to situations in which it cannot sell underwritten asset-backed securities. Credit review, funding capabilities, and approval limits should allow the branch to purchase and hold unsold securities. All potential credit exposure should be within prudential lending limits.
16. Ensure that internal systems and controls adequately track the performance and condition of internal exposures and monitor the branch's compliance with internal procedures and limits. In addition, verify that adequate audit trails and internal audit coverage are in place. Ensure that the internal reports are adequate in scope and frequency.
17. Determine that management information systems provide:
  - a. A listing of all securitizations in which the branch is involved.
  - b. A listing of industry and geographic concentrations.
  - c. Information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters.
  - d. Information regarding portfolio aging and performance relative to expectations.
  - e. Periodic and timely information to head office management on the branch's involvement in, and credit exposure arising from, securitization.
18. Check whether internal auditors review all facets of securitization on a regularly basis.
19. Review policies and procedures for compliance with applicable state and federal lending limits. These requirements must be analyzed to determine whether a particular asset-backed security issue is considered a single investment or a loan to each of the creditors underlying the pool. Collateralized mortgage obligations may be exempt from this limitation, if they are issued or guaranteed by an agency or instrumentality of the U.S. government.
20. Determine whether the underwriting of asset-backed securities of affiliates are:
  - a. Rated by an unaffiliated, nationally recognized statistical rating organization.
  - b. Issued or guaranteed by FNMA, FHLMC, or GNMA, or represent interests in such obligations.
21. Determine if purchases of high-risk mortgage-backed securities were made to reduce the overall interest rate risk of the branch. Determine if the branch evaluates and documents at least quarterly whether these securities have reduced its interest rate risk.
22. Review and discuss any documentation exceptions, violations, internal control exceptions, and classifications with management and obtain and document management's response.
23. Review the branch's liquidity agreements with any asset-backed commercial paper programs and determine whether the agreements have any credit related components. Is the branch required to purchase the assets? Are these assets repurchased from the branch? If the facility is determined to be a commitment, determine whether its maturity is short-term or long-term. Do any of the liquidity agreements contain a material adverse clause or any other credit contingency provision?

# Asset Securitization

## Internal Controls Questionnaire

Effective date July 1997

## Section 3030.4

Review the branch's internal controls, policies, practices, and procedures for all aspects of asset securitization. The branch'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. Does the branch employ the services of a securities dealer? If so, does the branch rely solely on the advice of such a dealer when purchasing asset-backed securities for the branch's investment portfolio? Does the branch have staff responsible for reviewing and approving the investment manager's acquisitions? Have minimum criteria been established for selecting a securities dealer?
2. To ensure a proper level of supervision over branch activities, has head office management reviewed and ratified asset securitization policies, practices, and procedures that:
  - a. Require an initial thorough and independent credit assessment of each asset pool for which the branch has assumed credit risk as either a participant in the securitization process or as an investor?
  - b. Address the repurchase of assets and other forms of reimbursement to investors by the branch when it is serving as the originator, packager, or underwriter in the event that a default results in losses exceeding any contractual credit enhancement?
  - c. Ensure that the credit, pricing, and servicing standards for securitized assets are equivalent to standards for assets that remain on the branch's books?
  - d. Ensure that the credit, pricing, and servicing standards and compliance with any provisions relating to government guarantees are reviewed periodically by head office management?
  - e. Establish in-house diversification requirements, within proper risk management techniques, regarding aggregate outstanding exposures to a particular institution, industry, or geographic area?

- f. Hedge the branch's exposure to adverse price movements when engaged in underwriting or market-making activities?
3. Are securitization policies reviewed and reaffirmed at least annually to determine if they are compatible with changing market conditions?

### INTERNAL CONTROL/MANAGEMENT INFORMATION SYSTEMS

4. Do the branch's internal systems and controls adequately track the performance and condition of internal exposures, and do the systems monitor the branch's compliance with internal procedures and limits? Are adequate audit trails and internal and external audit coverage provided?
5. Do the branch's cost accounting systems provide a reliable determination of the profitability and volatility of asset securitization activities?
6. Are management information systems and reporting procedures adequate, in that they:
  - a. Provide a listing of all securitizations for which the branch is originator, servicer, credit enhancer, underwriter, or trustee?
  - b. Provide a listing of industry and geographic concentrations?
  - c. Provide information on total exposure to specific originators, servicers, credit enhancers, trustees, or underwriters?
  - d. Provide information regarding portfolio aging and performance relative to expectations?
  - e. Provide periodic and timely information to head office management on the branch's involvement in, and credit exposure arising from, securitization?
  - f. Provide credit ratings assigned by independent rating agencies to all asset-backed securities held by the branch?

### CONCLUSION

7. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.

8. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

# Banker's Acceptances

Effective date July 1997

## Section 3040.1

One method of financing international trade is by the use of a banker's acceptance. Such an 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 across the face of the draft **ACCEPTED** and dating and signing the stamp, is a formal acknowledgement 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. Refer to the manual section entitled Letters of Credit. In general, acceptance credit is considered self-liquidating in that it provides the means for its own payment at maturity. Self-liquidation is accomplished because the acceptance must be based on a specific trade transaction in which goods are being shipped prior to entering the channels of trade. Therefore, satisfactory evidence should be available indicating that the draft, when created, is based on an actual shipment or storage. Furthermore, 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 Customers' 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 Customers' Liability on Acceptances and Bank's Liability on Acceptances outstanding and the loan and discount account is 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. However, 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 (12 USC 372), which establishes criteria that must be met in order for the instrument to be eligible for either discount or purchase by the Federal Reserve Banks. In addition, for federally-licensed branches, the eligible banker's acceptance limit is in addition to the loan and investment securities limits. 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 are acceptances that do not satisfy these conditions and, as such, provide a greater degree of liquidity for the accepting bank. Second, unlike eligible acceptances, ineligible acceptances are subject to reserve maintenance requirements, thus raising the cost to the borrower over that of an eligible acceptance. For federally-licensed branches, ineligible banker's acceptances are subject to the limits specified in 12 USC 84 and are combined with loans. The examiner must be familiar with the criteria used for determining eligibility for discount or purchase by the Federal Reserve Banks.

Branches that are subject to reserve requirements (i.e. controlled by an entity with \$1 billion in total worldwide consolidated assets) under Section 7 of the International Banking Act of 1978 (12 USC 3105(a)) are subject to the limitations described in Section 13 of the Federal

Reserve Act (12 USC 372). These regulations limit the amount of eligible banker's acceptances that may be created to 150 percent (or 200 percent with the permission of the Board) of the paid up and unimpaired capital stock and surplus of the foreign banking organization (FBO). In addition, all U.S. branches of an FBO are prohibited from creating eligible banker's acceptances for any one person in the aggregate in excess of 10 percent of the FBO's capital. Eligible banker's acceptances growing out of domestic transactions are not to exceed 50 per-

cent of the aggregate of all eligible acceptances authorized for a branch.

Banker's acceptances, as a source of finance 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, because it is readily marketable, is considered an important secondary reserve for the accepting bank, and is a relatively secure investment to the investor because of its two-name backing.

# Banker's Acceptances

## Examination Objectives

Effective date July 1997

## Section 3040.2

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1. To determine if objectives, policies, practices, procedures, and internal controls regarding banker's acceptances are adequate.
2. To determine if branch 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 federal and state laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Banker's Acceptances

## Examination Procedures

Effective date July 1997

## Section 3040.3

1. If selected for implementation, complete or update the Internal Control Questionnaire for this section.
  2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
  3. Review the bankers acceptance section of the lending policy for adequacy.
  4. Check scope of internal audit to ensure that it covers a review of bankers acceptances.
  5. Reconcile balances to departmental controls and the general ledger.
  6. Verify that appropriate accounting methods are used and that regulatory reports are accurately prepared.
  7. Determine that there is appropriate segregation of duties in that:
    - a. Individuals who prepare and post BA records also do not issue official checks or handle cash,
    - b. Individuals who perform reconciliations and certifications also do not process acceptances, and
    - c. Persons who investigate exceptions and respond to inquiries do not normally process acceptances.
  8. Ensure the branch has an adequate system to track outstanding exceptions and delinquencies.
  9. Ensure that acceptances are registered in some manner (manual log book or computer system), consecutively numbered, and identified by type of transaction so as to leave an audit trail.
  10. Review procedures for safeguarding blank, accepted, and pre-signed documents and drafts.
  11. Review procedures for determining BA eligibility. Ensure that ineligible acceptances are appropriately segregated from the eligible acceptances. Ineligible acceptances cannot be discounted at the Federal Reserve and are treated as reservable liabilities.

*Eligibility can be determined by reviewing documentary evidence detailing the nature of the transaction underlying the credit extended. This evidence may be in the form of correspondence, title documents, or document transmittal letters that 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.*
12. Review procedures for financing clean acceptances (*i.e. when the title and shipping documentation is not processed by the office*) to ensure they include:
    - a. Details of the shipment such as invoice amount, type of commodity or merchandise, ports of embarkation and debarkation, and the bill of lading date.
    - b. Certification that duplicate financing does not exist.
    - c. An agreement by the customer to provide copies of invoices and bills of lading to the branch upon request.
  13. Review procedures for monitoring the stipulated aggregate liability limitations on outstanding acceptances. Systems should be in place to monitor the global customer exposure on the aggregate outstanding amount on a consolidated basis which cannot exceed 150% of parent bank capital.
  14. Select a sample of bankers acceptances created for specific borrowers and review credit files for credit risk. Forward findings to examiner in charge of loan review.
  15. Ensure the branch has procedures in place to comply with OFAC and Anti-Boycott provisions.
  16. Prepare, in appropriate format, the findings and conclusions regarding:
    - a. The adequacy of policies relating to banker's acceptances.
    - b. Whether branch 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. Other matters of significance.
17. Update the workpapers with any information that will facilitate future examinations.

# Banker's Acceptances

## Internal Control Questionnaire

Effective date July 1997

Section 3040.4

### POLICIES

1. Have policies been adopted 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 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 handle cash or issue official checks or drafts?
4. Are the subsidiary banker's acceptance records balanced daily with the appropriate general ledger accounts and are 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., banker's 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 branch's records from the branch's own acceptances purchased?
10. Are prepayments on banker's acceptances netted against the appropriate asset account Customer Liability for Acceptances Outstanding (or loans and discounts, depending upon whether the branch has discounted its own acceptance), and do they continue to

be shown as a liability under Bank's Liability on Acceptances Outstanding?

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 handle cash or issue official checks or drafts?
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 handle cash or issue official checks or drafts?

### OTHER

14. Are acceptance record copies, own acceptances discounted (purchased) and acceptances of other banks purchased safeguarded during banking hours, locked in the vault overnight, and periodically inventoried?
15. Are blank (pre-signed) customer drafts maintained under dual control in the vault, numbered, inventoried monthly, and verified with the customer on a monthly basis?
16. Are any acceptance fee rebates approved by an officer?
17. Does the branch have an internal review system that:
  - a. Reviews 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.
  - d. Determines that the individuals to whom funds are being disbursed are authorized by the beneficiary to receive the funds?
  - e. Addresses funding procedures for rediscounted acceptances?

- f. Tests for compliance with IBF restrictions?
18. Does the branch'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?
19. Is the information covered by this internal control questionnaire adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
20. Based on the information gathered, evaluate internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

## CONCLUSION

19. Is the information covered by this internal control questionnaire adequate for evaluat-

Generally, commercial loans comprise the largest asset concentration of a branch, offer the most complexity, and require the greatest commitment from branch 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 branch operates, most commercial and industrial loans will primarily be made in the form of a working-capital loan, term loan, or loan to an individual for a business purpose. This section will provide examiners with a fundamental understanding of secured and unsecured transactions, the key principles for assessing credit quality, and basic bankruptcy law. Other sections of this manual discuss more specific types of lending.

## TYPES OF COMMERCIAL LOANS

### Working Capital or Seasonal Loans

Working capital or seasonal 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 line of credit is a revocable commitment by the branch to lend funds up to a specified period of time, usually one year. Lines

of credit are generally reviewed annually by the branch, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the branch has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving line of credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee (i.e. firm commitment) 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 up to the agreed limit. Repayment is generally accomplished through the conversion or turnover of short-term assets, such as inventory or accounts receivable. Interest payments on working capital loans are usually paid throughout the term of the loan, such as monthly or quarterly.

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, 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 branch 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 Working-Capital Loans

The analysis of a working-capital 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 branch, all credit facilities should be reviewed at the same time to ensure that the activity with the working-capital facility is not used to pay interest on other loans in the branch. Projections of sources and uses of funds are also a valuable tool for reviewing a 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 branch will only lend up to a predetermined specified percentage of total outstanding receivables less all 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 working-capital loans, examiners should remember that a branch 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 branch 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 payout or cleanup may be exceptions and qualify for unsecured lending. 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 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 acquired with term business loans.
- *Trade creditors not paid out at end of business cycle.* While the branch 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 branch 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 branch's credit policy for the specific assets being financed.
- *Value of inventory declines.* When a business does not pay back the branch 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 branch 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; or (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 branch 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 will usually prompt criticism of the credit.

## Term Loans

Term 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 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 usually secured. Loan interest may be payable monthly, quarterly, semiannually, or annually. Loan principal should amortize with the same frequency in order to fully pay off the loan at maturity.

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. In affirmative covenants, the bor-

rower 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 and payments. 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 branch management.

## Analysis of Term Loans

While a 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 branch 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 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 be solved only 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.

## Shared National Credits

Regulatory agencies participate in a program for the uniform review of shared national credits (SNC). A SNC is defined as any loan, commitment, or group of loans or commitments aggregating \$20 million or more at origination that is:

- Committed under a formal lending arrangement.
- Shared at its inception by two or more supervised institutions or sold to one or more

institutions with the purchasing entity assuming its pro rata share of the credit risk.

A single facility with different terms and/or participants for tranches should be reported as separate credits. Loans sold to affiliate banks of the same holding company are not part of the SNC program.

If the outstanding balance or commitment of a SNC falls below \$20 million after its inception, and it is not criticized, the credit will not be reviewed at the next review date. Therefore, the examiner should conduct an individual review of the credit at the branch under examination. However, if the former SNC facility fell below the threshold through a charge-off, and was classified or specially mentioned at the most recent SNC review, the credit relationship would continue to be reviewed under the SNC program until such time that the balance falls below \$10 million. The Federal Deposit Insurance Corporation (FDIC), the state agencies, and the Office of the Comptroller of the Currency (OCC) also participate in this program. The Federal Reserve carries out the examination of SNCs at the lead or agent banks that are state-member banks, state-chartered foreign branches, and credit-extending nonbank subsidiaries of domestic and foreign organizations. The FDIC is primarily responsible for any SNC credits at state non-member banks, and the OCC supervises the review of those SNCs in which the lead bank is a national bank or an OCC-chartered foreign branch.

SNCs should not be analyzed or reviewed during the examination of the individual participating branch. If the examiner is uncertain whether the credit was reviewed under the SNC program, the respective Reserve Bank coordinator should be contacted. If credits eligible for the program are found but have not been reviewed (other than new SNCs since the time of the last SNC program review), the examiner should submit a memorandum detailing those credits to the respective Reserve Bank coordinator to be forwarded to the SNC coordinator at the Federal Reserve Bank of New York.

The SNC program does not track subparticipations. A subparticipant is a banking organization that has purchased a share from either a bank in the original syndicate or from a bank considered a first-tier participant. Therefore, if the bank is a subparticipant in a credit, it will not appear in the "Report of Lenders and their Borrowers". However, the credit may have been

reviewed by the SNC Program and examiners can obtain the results of such a review by calling the SNC coordinator for their agency.

## 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 branch'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 branch'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 is attached.

- 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 UCC 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 creditor secures an interest in property. Perfection provides the branch assurance that it has a legal 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 is attached (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,<sup>1</sup> 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 branch 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 few 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 branch's customer operates. Most importantly, it is the location of the borrower, not the branch, 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

<sup>1</sup> 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.

of the collateral<sup>2</sup>

- *Amendments.* Not all amendments require the borrower's signature, and branches 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 still effective. 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/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 any event, the lender should conduct a title search after the mortgage is recorded to ensure that his position has not been compromised.
- 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

2. 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.

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/or 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 branch'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.

## Emerging Problem Loans

The following are key signals of an emerging problem loan:

- *Outdated or inaccurate financial information.* The borrower is unwilling to provide the financial institution with a current, complete, and accurate financial statement at least annually. Management also should request 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 branch 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.* Repayment sources are often not identified and are unpredictable. 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.

## 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 of 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.

### Components of the Accrual Conversion Method of Cash Flow

<i>Category</i>	<i>Basis for Amount</i>
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 principals is necessary to competently review an unaudited financial statement. At a minimum, financial statements should be obtained annually; where appropriate, the branch also should obtain monthly or quarterly statements.

When reviewing a credit file of a borrowing customer of a branch, 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 these 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 branch 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.

## BANKRUPTCY LAW AND COMMERCIAL LOANS

This section provides examiners with an overview of the United States Bankruptcy Code (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 pre-bankruptcy 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. In rare situations, other chapter 7 bankruptcies may 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 bankruptcy under chapter 11. 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.

# Commercial Loans

## Examination Objectives

Effective date July 1997

## Section 3050.2

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1. To determine if lending policies, practices, procedures, and internal controls regarding commercial loans are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To evaluate the portfolio for credit quality, performance, collectibility, and collateral sufficiency.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Commercial Loans Examination Procedures

Effective date July 1997

## Section 3050.3

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Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of commercial lending activities. However, if the branch conducts significant commercial lending activities, and additional information is needed, the examiner should perform the following procedures.

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been addressed by management.
3. If the branch has any credits that should be reviewed under the Shared National Credit program but were omitted (other than new credits that originated since the previous review) submit a memorandum to the SNC coordinator detailing those credits to the respective Federal Reserve District. Do not include subparticipations, where the branch purchased its share from either a bank in the original syndicate, or from a bank considered a first-tier participant. Subparticipations should only be tracked internally by the branch.

# Commercial Loans

## Internal Control Questionnaire

Effective date July 1997

## Section 3050.4

Refer to the Credit Risk Management internal control questionnaire for a general review of the branch's internal controls, policies, practices, and procedures. If additional information is needed, complete the following internal control questionnaire. For audit procedures, refer to the Credit Risk Management section 3010.5.

### POLICIES

1. Has the head office adopted written commercial loan policies for the branch that:
  - a. Establish procedures for reviewing commercial loan applications?
  - b. Define qualified borrowers?
  - c. Establish minimum standards for documentation?
2. Are policies reviewed, at least annually, to determine if they are compatible with changing market conditions?
3. Do loan records provide satisfactory audit trails that permit the tracing of transactions from initiation to final disposition?
4. Has the branch instituted a system that ensures:
  - a. Security agreements are filed?
  - b. Collateral mortgages are properly recorded?
  - c. Title searches and property appraisals are performed in connection with collateral mortgages?
  - d. Insurance coverage, including loss payee clause, is in effect on property covered by collateral mortgages?
  - e. The borrower is in compliance with all the covenants of the loan agreement?
5. Does the branch have an internal review system that:
  - a. Ensures liens are perfected?
  - b. Checks collateral values when the loan is made and at reasonable intervals thereafter?
  - c. Ensures that cash flow analyses are performed on appropriate borrowers in a timely manner?
  - d. Determines that loan payments are promptly posted?
6. Do working capital loans require clean-up periods?
7. Who is responsible for monitoring the clean-up period, the account officer or an independent source?
8. What are the consequences if the borrower cannot clean-up the line?
9. Are different criteria used for loans to borrowers on an unsecured basis versus a secured basis (e.g. more stringent documentation requirements, more frequent credit reviews, or cashflow analyses)?
10. Is there any evidence that the branch is extending working capital loans to finance the acquisition of long-term assets or capital?
11. Do all term loans require meaningful principal amortization (at least quarterly)?
12. Does the term of the loan correspond to the useful life of the underlying asset being financed?

### CONCLUSION

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

Corporate restructurings have become a technique for financing acquisitions through leveraged buyouts, resisting takeovers, and restructuring corporate balance sheets. They encompass traditional leveraged buyouts, management buyouts, corporate mergers and acquisitions, and significant stock buybacks. Leveraged Employee Stock Option Plans (ESOPs) may also be considered as corporate restructurings if they are used to acquire or recapitalize an existing business.

It is not considered inappropriate for branches to lead and/or participate in loans to finance corporate restructurings so long as they are conducted in a sound and prudent manner. However, booking of such credits could affect asset quality and increase overall levels of risk exposure.

Corporate restructurings involve many of the same characteristics and risks that have traditionally been evaluated during on-site examinations. These relate to the borrower's income, cash flow, and general ability to pay interest and principal on outstanding debt; economic conditions and trends; the borrower's management; and the borrower's ability to realize value through the sale or liquidation of assets. What usually distinguishes corporate restructurings from typical bank loans is the level of debt the borrower assumes in relation to standard measures of financial capacity or ability to repay. Clearly, a high level of debt in relation to net worth or total assets can place heavy demands on a borrower's cash flow and reduce the borrower's ability to absorb the effects of unanticipated financial shocks or economic adversity.

Branches may be involved in corporate restructurings at a number of levels. First, they, together with other institutional lenders, may provide senior secured financing that typically represents the largest portion of a corporate restructuring. In addition, branches may extend credit on a subordinated basis. Bridge loans also represent another type of financing, which may be considered as senior debt or mezzanine financing, depending on its characteristics.

Because corporate restructurings traditionally entail high leverage, they often increase the vulnerability of borrowers to adverse market and financial developments and have the potential to raise the level of risk in bank loan portfolios. For these reasons, bank supervisors have actively urged bank management to exer-

cise caution and apply especially rigorous lending and investing standards in participating in these transactions.

## WAYS TO FINANCE CORPORATE RESTRUCTURINGS

Corporate restructurings are typically financed through a complex combination of debt and equity instruments. A general overview of the types of financings is provided as follows:

### Senior Debt

This term refers to all loans and debt securities secured by first liens on assets or the stock of the borrower's operating entities; and, any unsecured loans and debt securities, which have priority in repayment over all other creditors and equity investors in the event of liquidation. The majority of senior debt generally consists of secured term loans; however, other types of debt, including revolving working capital loans, bridge loans, and debt securities may be considered senior debt. To be considered as senior debt, the loans must not be subordinated to any other obligations in the event of liquidation.

### Mezzanine Financing

Mezzanine financing consists of all layers of financing between senior debt and equity investments. These include all unsecured loans and debt securities where payment is subordinated, loans or debt securities secured by liens inferior to those of senior debt, fully subordinated debt, and any limited-life preferred stock with significant debt characteristics.

### Bridge Loans

Bridge loans have varying characteristics and are considered as either senior debt or mezzanine financing based upon the definitions above. Repayment of bridge loans is dependent on the successful marketing of longer term securities or the sale of assets for repayment. Bridge loans that would be subordinated to other obligations

in the event of liquidation are considered mezzanine financing.

### Noninvestment Grade Bonds

These bonds consist of all noninvestment-grade, high-yield debt securities involved in corporate

restructurings (commonly referred to as junk bonds). This includes various types of high yield issues, which have attributes of debt, such as zero-coupon or zero-slash bonds and pay-in-kind (PIK) bonds. Pay-in-kind preferred stock and other issues with significant equity attributes are considered equity investments.

# Financing Corporate Restructurings

## Examination Objectives

Effective date July 1997

## Section 3060.2

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1. To determine if policies, practices, procedures, and internal controls regarding corporate restructurings are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines.
3. To determine compliance with applicable laws and regulations.
4. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Financing Corporate Restructurings

## Examination Procedures

Effective date July 1997

## Section 3060.3

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Determine if management performs the following:

1. Evaluates the adequacy and stability of the borrower's current and prospective cash flow under varying economic scenarios, including the possibility of an economic decline.
2. Sets reasonable in-house limits regarding exposure to individual borrowers, total exposure to all corporate restructured borrowers, and industry concentrations resulting from corporate restructurings.
3. Establishes credit analysis, approval, and review procedures that take account of the high levels of debt involved in these transactions.
4. Maintains internal systems, controls, and reporting procedures that track the performance and condition of individual exposures, monitor the organization's compliance with internal procedures and limits and keep head office management adequately informed on a timely basis of the organization's involvement in corporate restructurings.
5. Establishes pricing policies and practices that take into account a prudent manner of the trade-off between risk and return.
6. Avoids compromising sound banking practices in an effort to broaden market share or realize substantial fees.

This section refers to deposit accounts with nonrelated banking organizations. These deposit accounts can be either noninterest-bearing settlement accounts (demand) or interest-bearing deposits and placements (time). For information on accounts with *related* banking offices and affiliates see the Due From/Due To Related Offices section of this manual. In addition, the instructions for the FFIEC 002, Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks, are an important source of information on accounts with nonrelated and related offices and institutions.

### DEMAND DEPOSITS

Banks maintain deposits in other banks to facilitate the transfer of funds. Those assets, known as due from banks-demand, correspondent bank balances, or settlement accounts, are a part of the primary, uninvested funds of every bank. A transfer of funds between banks may result, in part, from the collection of cash items, the transfer and settlement of securities transactions, the transfer of participating loan funds, and the purchase or sale of Federal funds.

Banks also utilize other banks to provide certain services that can be performed more economically or efficiently by the other banks because of their size or geographic location. Such services include processing of cash letters, packaging loan agreements, funding overline loan requests of customers, performing EDP services, collecting out-of-area items, exchanging foreign currency, and providing financial advice in specialized loan areas. When the service is one-way, the bank receiving that service usually maintains a minimum balance that acts as a compensating balance in full or partial payment for the services received.

Some banks, particularly branches, must be prepared to make and receive payments in foreign currencies to meet the needs of their international customers. This can be accomplished by maintaining foreign currency due from banks-demand accounts with affiliates (nostro balances) or with other banks in foreign countries.

### TIME DEPOSITS

Branches also maintain interest-bearing time deposits, known as due from banks-time, with other banks. Those assets may also be referred to as placements, placings, interbank placements (deposits), redeposits or even Federal funds, in instances where their maturities are similar to Federal funds. These placements represent a source of primary liquidity to many branches.

All banks with which the branch has demand and time accounts shown on its books should be subject to an appropriate level of scrutiny for creditworthiness, which should be documented in the branch's on-site credit files. In cases, where these credit evaluations are conducted by the head office or another related office, branch management should obtain copies of these evaluations for its files.

Due from banks-time deposit activities became important with the growth of the Eurodollar market. The bulk of due from banks-time deposits now consist of Eurodollars, with smaller amounts in other Eurocurrencies. Other foreign currency time deposits are placed in substantially the same manner as Eurodollar deposits, subject to differing exchange control regulations or local customs.

Eurodollar (interbank) deposits are sometimes linked with foreign exchange transactions. As a result, the branch's foreign exchange or Eurocurrency deposit traders frequently work closely with the trader responsible for placing due from banks-time deposits. Foreign exchange brokers also may act as intermediaries if warranted by market conditions, local customers, the size of the branch, or other factors.

The practice of placing interbank deposits (and takings on the liability side) originated in London because, under U.K. regulations, banks were entitled to "accept" interbank deposits whereas interbank borrowings (i.e. loans) required authorization by the Bank of England. Therefore, due from banks-time deposits are "accepted" even though the receiving bank may have instructed its foreign exchange trader, directly or through brokers, to find a bank willing to offer it such deposits.

Due from banks-time deposits contain the same credit and country risks as any extension of credit to a bank. Consequently, a prudently managed bank should place deposits with (i.e. lend to) only well-managed banks. The traders

should be provided with a list of approved banks with which funds can be deposited up to prescribed limits for each bank. Due from bank-time deposits differ from other types of credit extensions because they often represent deposits of relatively short maturity which normally receive first priority in case of insolvency. Nevertheless, the credit and country exposure exists, and customer limits must be established by credit officers and not by foreign exchange traders. Such limits must be reviewed regularly by credit officers, particularly during periods of money market uncertainty or rapidly changing economic and political conditions.

The examiner also must recognize that credit risks intensify when due from bank-time depos-

its are placed for longer periods. Furthermore, the credit risks for specialized or smaller banks that have recently entered the interbank deposit market can be far greater than that for larger, long-established banks. Banks which traditionally utilized only regular lines of credit or special facilities also have entered the due from banks-time deposit market to meet their external needs. Those banks could be the first to be caught in a market crunch.

Incoming confirmations from banks must be meticulously checked by the bank to record copies in each instances to protect against fraud and errors. Similarly, a systematic follow-up on non-receipt of incoming confirmations should be carefully monitored by the bank.

# Due From Nonrelated Banks

## Examination Objectives

Effective date July 1997

## Section 3070.2

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1. To determine if the policies, practices, procedures, and internal controls regarding balances due from banks, both demand and time, are adequate.
2. To determine if branch officers and employees are operating in conformance with established guidelines.
3. To determine that all due from accounts are reasonably stated and represent funds on deposit with other banks.
4. To determine whether the branch evaluates the credit quality of banks with which demand and time accounts are maintained.
5. To determine the scope and adequacy of the internal and external audit coverage as it applies to this area.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law, rulings, or regulations have been noted.

# Due From Nonrelated Banks Examination Procedures

Effective date July 1997

## Section 3070.3

1. If included in the scope of the examination, complete or update the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls within the parameters of the established scope.
3. 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.
4. 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.
5. 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.
6. Obtain a trial balance of the due from banks—time balances. Reconcile balances to department controls and general ledger.
7. Check a sample of confirmations. This will ensure that the balances are indeed due from bank balances and not loans to banks (for Call Report purposes). If any transactions are not confirmed as of the date of examination, determine why incoming confirmation is missing.
8. The credit quality of placements is included in the scope of the asset quality review. Using appropriate sampling techniques, select deposit customers for examination and review the credit file maintained on each bank. Ensure the bank has performed a credit analysis on all approved due from bank counterparties. If the credit analysis has been prepared by the head office, shadow files need to be maintained at the institution.
9. Check back office procedures, adequacy of separation of duties, and who monitors limits.
10. If problems are detected concerning the institution's policies or lack thereof, the deficiencies should be discussed under Risk Management. If the institution is deficient in its operations and is not following its policies, the exception should be discussed under Operational Controls.
11. Prepare comments on deficiencies or violations of law noted above for inclusion in the examination report.
12. Assemble workpapers to support conclusions reached. Include any information that will facilitate future examinations.

# Due From Nonrelated Banks

## Internal Control Questionnaire

Effective date July 1997

Section 3070.4

### AUDIT COVERAGE

1. Does the scope of the branch's internal audit program include procedures covering:
  - a. Due from banks-demand accounts?
  - b. Due from banks-time accounts?
2. Do audit procedures include all of the following to ascertain the effectiveness of internal controls:
  - a. Ensure that procedural manuals or instructions covering the reconciliation function exist?
  - b. Ascertain if statements are not reconciled by an individual, who also:
    - Has signing authority on the account?
    - Approves entries?
    - Posts the general ledger?
    - Effects money transfers?
  - c. Ensure that statements are reconciled promptly when received?
  - d. Check to see that reconcilements are prepared on preprinted forms?
  - e. Ensure that completed reconcilements are properly stored to satisfy record-retention requirements?
  - f. Ensure that open items are promptly referred to and followed up by the appropriate operating department or responsible officer?
  - g. Test that open entries outstanding beyond a reasonable length of time are:
    - Referred to appropriate senior branch management in writing?
    - Charged off to profit/loss accounts?
    - Transferred to special suspense accounts, pending additional follow-up action?
  - h. Ensure that reconciliation personnel are prohibited from preparing adjusting entries?
  - i. Spot check selected general ledger tickets and supporting documentation for:
    - Adequate details of the transaction?
    - Proper officer approvals?
  - j. Test check on selected transactions that include open, reconciled, adjusted, and charged-off items to ascertain propriety of disposition?

### POLICIES FOR DUE FROM BANKS

3. Do current written policies and procedures exist for due from banks-demand 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?
4. Do current written policies and procedures exist for due from banks-time account that:
  - a. Establish maximum limits of the aggregate amount of due from banks-time deposits for each:
    - Bank?
    - Currency of deposit?
    - Country of deposit?
  - b. Restrict due from banks-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 cut-off deadlines?
    - Handling of interest?
5. Are the policies and procedures for due from bank accounts reviewed at least annually to determine their adequacy in light of changing conditions?

**BANK RECONCILEMENTS**

6. Are branch reconcilements prepared promptly upon receipt of the statements?
7. Are statements examined for any sign of alteration and are payments or paid drafts compared with such statements by the persons who prepare branch reconcilements? If yes, skip question 8.
8. If the answer to question 7 is no, are statements and paid drafts or payments handled before reconciliation 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?
9. Are branch reconcilements prepared by persons who do not also:
  - a. Issue drafts or official checks?
  - b. Handle cash?
  - c. Prepare general ledger entries?

11. Are overdrafts in due from bank accounts properly recorded on the branch's records and promptly reported to the responsible officer?
12. Are individual interest computations checked or adequately tested by persons independent of those functions?
13. Are accrual balances for due from banks-time verified periodically by an authorized official? If so, indicate frequency.
14. Do all internal entries require the approval of appropriate officials?

**CONCLUSION**

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

**OTHER**

10. Is a separate general ledger account or individual subsidiary account maintained for each due from bank account?

# Due From Nonrelated Banks

## Audit Guidelines

Effective date July 1997

## Section 3070.5

1. Determine the number of the last unissued draft of each due from bank account and record for comparison when performing reconcilements.
  2. Prepare a listing of all due from bank accounts, together with their balances from the branch's daily statement as of the examination date. Compare each balance or total balances to the appropriate subtotal in the general ledger as of the examination date.
  3. Request a cut-off statement as of the examination date and for a subsequent date, not less than five days later for each due from account. Include instructions that the statements be addressed to the examiner-in-charge and be delivered unopened.
  4. In preparing or reviewing reconcilements:
    - a. Review reconciling items carefully to determine that the time period between debit or credit entries and the offsetting credit or debit by the correspondent bank is comparable for similar types of items. If any differences in timing occur, ascertain the reason.
    - b. Determine that wire transfers appear on the correspondent statement the same day as entered on the branch's books. Determine the reason for any exception.
    - c. Test all drafts included in the cut-off statement for authorized signature, proper endorsement, dates of drafts, payee, and amounts and determine that:
      - Dates drawn are not subsequent to dates paid by the correspondent bank.
      - Drafts issued to transfer funds from the branch's account to the correspondent's account are not outstanding more than the normal transit time.
      - Drafts are numbered.
      - Drafts are issued sequentially.
  5. Reconcile due from bank accounts on a reconciliation form using the following steps:
    - a. Prove the mathematical accuracy of the prior reconciliation by a machine run of the figures.
    - b. Determine that *our balance to their debit* agrees to general ledger as of their prior reconciliation date.
    - c. Determine that *their balance to our credit* agrees to each correspondent bank statement as of the prior reconciliation date.
  - d. Determine that the closing balance and date listed on the statement used in the branch's last reconciliation agrees to the opening balance and date listed on the cut-off statement as of the examination date.
  - e. Determine that any open items from previous reconcilements have cleared.
  - f. If any items on a previous reconciliation do not clear, list on the reconciliation form being prepared.
  - g. Determine that each debit and credit entry shown on the general ledger since the date of the last reconciliation is offset by a corresponding credit or debit on the correspondent bank's cut-off statement.
  - h. Any items on the general ledger, except outstanding drafts, that are not offset by an appropriate debit or credit on the correspondent bank's cut-off statement are considered open and should be transferred to the reconciliation form under the appropriate we debit or we credit caption along with the date and a brief description.
  - i. Any items on the correspondent bank's cut-off statement that are not offset by an appropriate debit or credit on the branch general ledger are considered open and should be transferred to the reconciliation form under the appropriate they debit or they credit caption along with the date and a brief description.
  - j. "We credit" items that represent drafts outstanding should not be listed on the "we credit" section of the reconciliation form. Each outstanding draft should be listed by number on the reverse side of the reconciliation form and the total should be carried forward opposite the caption drafts outstanding. The listing should include any drafts still outstanding from the previous reconciliation.
  - k. Prove the reconciliation.
6. Determine clearance of "we debit" and "we credit" items using later cut-off statements, when available, and:
    - a. If an item is cleared by reversing the entry, that is, by a subsequent offsetting debit or credit entry on the ledger of the branch under examination, check the entry through to its source.

- b. All material “we debit” and “we credit” items that do not clear on the later cut-off statements received should be confirmed, with a copy of the confirmation tracer retained for comparison to the original after it is returned.
7. Utilizing the general ledger or appropriate subsidiary ledger, determine clearance of “they debit” and “they credit” items. The reason for nonclearance should be determined for all “they debit” and “they credit” items that do not clear in a reasonable amount of time.
8. Review the accrued interest accounts by:
  - a. Reviewing and testing procedures for accounting for accrued interest and for handling adjustments.
  - b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
9. Obtain or prepare a schedule showing the accrued interest balances and the deposit balances for selected time periods since the previous examination.
  - a. Calculate ratios.
  - b. Investigate significant fluctuations and/or trends.

Financing foreign receivables includes open account financing, sales on consignment, advances against collections, banker's acceptances, factoring, and forfaiting. Certain foreign receivables are guaranteed or insured for credit and political risk by the Export-Import Bank of the United States, the Foreign Credit Insurance Association, or other American and foreign organizations.

### OPEN ACCOUNT FINANCING

The simplest method of financing foreign receivables is on open account. In such a sale, the buyer and seller agree on payment at a specified date without any negotiable instruments, 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 the buyer to make payment to the bank in which the exporter maintains an account. The advantages of an open account sale are its simplicity and the lack of bank charges and stamp duties applied to drafts by certain countries.

The financing of open account sales contains certain risks. The lending bank and exporter have no control over the documents and the buyer (importer) may take possession of the goods without the bank's or the exporter's consent. In addition, if the importer does not register the goods with the proper authorities, the dollar or other exchange may not be available at the time of payment. Probably 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 (importer) is a subsidiary of a related company or is well-known to the seller.

### 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 credit risk is

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 in a bonded warehouse 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 many foreign banks until all pertinent conditions, regulations, and storage facilities are verified. The exporter's bank also should verify that goods not sold may be returned to the country of origin. Bank financed consignment shipments should be limited to those countries that do not have burdensome foreign exchange restrictions and 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. That practice means that the exporter, in the case of a time or arrival draft, and the exporter and the importer, jointly, in the case of a sight draft, finance(s) the shipment. The exporter and the importer may have unused credit lines with their banks and be able to borrow the needed money without tying the financing to the trade transaction. Often, however, the exporter's or the importer's regular bank lines are used up for other transactions. Consequently, they may ask their bankers to provide financing through advances against outward collections, discounting trade acceptances, bankers' acceptances, factoring, or forfaiting.

### ADVANCES AGAINST FOREIGN COLLECTIONS

A manufacturer or merchant conducting a strictly domestic business often gets a loan from a bank, finance company, factor, or forfaiter by using accounts receivable as security. Because outward collections are the same as foreign receivables,

the same general type of financing vehicle is available to exporters.

A common method of financing foreign receivables is for the exporter to pledge 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 collections, they are usually paid on demand enabling the exporter to increase or decrease the loan depending on need 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 the foreign collecting bank to the domestic bank that has advanced the funds. The latter 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 collection. In such instances, the branch may be willing to advance money with only that one receivable as security. Again, the branch establishes a maximum percentage of the amount of the draft that it is willing to advance. When payment for the receivable is obtained, the branch uses the proceeds to liquidate the loan, crediting any excess to the exporter. Bank financing in the form of advances against export collections is an accepted practice in international trade and is not considered factoring.

Besides having a pledge on the exporter's outward collections, the branch usually retains recourse to the exporter whose financial condition and repayment history are of prime importance. Other factors, however, are also significant. If the foreign importers are prime companies with undoubted financial strength and repayment history, the branch will probably advance a larger percentage on collections directed to them. The branch will also advance a larger percentage of funds to importers in those countries that 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 branch will advance a lower percentage on collections. Certain collections to habitually slow paying importers or countries may be entirely ineligible for financing.

When a branch advances against foreign col-

lections, it must carefully scrutinize the supporting documents. Because the branch 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 branch. The bill of lading must not be consigned to the buyer (importer); otherwise, the buyer has control over the goods. In addition, shipments financed should be covered by adequate insurance.

## DISCOUNTING TRADE ACCEPTANCES

A draft accepted by the foreign buyer becomes a trade acceptance, carrying the full credit obligation of the importer. Such 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 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 branch to discount the draft with or without recourse. If the primary obligor (acceptor) is a well-known company of good credit standing, the branch 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 branch advances the face amount of the draft to the exporter, minus discount charges, until the maturity date. In that case, the branch is buying the trade acceptance for value and is entitled to any benefits due it from the primary obligor as a holder in due course of a negotiable instrument. That is also the case whenever the branch makes 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, branches may

choose to finance foreign collections by using banker's acceptances. Banker's acceptances are discussed separately in this manual, 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 (importer) that, along with the necessary documents, is sent for collection in the usual manner. The other draft, for the same or smaller amount as agreed on by the branch and exporter, is drawn by the latter on the branch and has the same tenor as the draft drawn on the importer. The branch accepts the latter draft and discounts it, crediting the net amount to the exporter's account. The branch has now created a banker's acceptance that can be sold in the highly liquid acceptance market. When payment is received from the importer, the branch applies the proceeds to pay its own acceptance, which will be presented for payment if sold in the market. Should the importer default, the branch has recourse on the drawer and can demand payment from that source.

## FACTORING

A factor buys accounts receivable with or without recourse. In the past, factoring was used primarily in domestic trade in certain industries, such as textiles. In recent years, however, several domestic factors have established foreign affiliates or invested in foreign finance companies and several banks have purchased or established factoring firms to finance foreign trade. Branches are also financing foreign trade by factoring.

Factoring is the purchase, on a without recourse basis, of the accounts receivable of a client. Factoring differs from asset-based lending financing, in that the factor assumes the credit and collection risk associated with the receivables. In asset-based lending these risks remain with the client. Among the principal advantages of factoring to the client, is that the client is certain of the collection of the proceeds of its sales, regardless of whether or not the factor is paid. Other advantages of factoring are that the client does not have to maintain a credit department to evaluate the creditworthiness of customers and collect past due accounts or

maintain bookkeeping or accounting records pertaining to the status of receivables. These responsibilities have been assumed by the factor. In addition, under the terms of an advance factoring arrangement, the client receives payment for its receivables before the time agreed upon under the normal terms of the invoice.

Maturity factoring and advance factoring are two basic types of service offered by the industry. In maturity factoring, an average maturity due date is computed for the receivables purchased during a period and the client receives payment on that date. Advance factoring uses the same computations; however, the client has the option of taking advance payments equal to a percentage of the balance due at any time prior to the computed average maturity due date. The unadvanced balance, sometimes called the client's equity, is payable on demand at the due date.

The typical factoring agreement stipulates that all accounts receivable of a client are assigned to the factor but not all are purchased without recourse. The agreement between the factor and the client will usually state that receivables subject to shipping disputes, errors, returns, and adjustments are chargeable back to the client because they do not represent bona fide sales. In addition, sales made by the client without the factor's approval are considered client risk receivables, with full recourse to the client if the customer fails to pay. 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 will conduct a credit review, determine the creditworthiness of the customer and approve or reject the sale. If the credit department rejects the sale, the client may complete the sale but at the client's own risk. The most commonly rejected sales are those to affiliates, to known bad risks, to customers whose credit cannot be verified, and to those customers whose outstanding payables exceed the factor's credit line to those customers.

Once a sale has been made and the receivable, whether or not approved, is assigned to the factor, 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 in advance or at the computed date, depending upon the basis of the factoring arrangement.

## Factoring Foreign Receivables

A factor who purchases a foreign receivable must approve the credit standing of a specified foreign obligor before the sales contract is concluded. If the foreign buyer's credit is not approved, the exporter may still make the shipment but at its own risk. If shipments to approved importers are made on a documentary collection basis, the drafts and documents are submitted to the factor who purchases them without recourse. The factor pays the money to the exporter either at the average maturity date, when actually received or, if financing is also required, immediately. Thereafter, the drafts and documents are routed through commercial banks for collection. Because the factor owns the drafts and documents, the collection process is undertaken for its account. Occasionally, a factor will make use of its own credit line with a commercial bank to carry receivables purchased from the exporter until payment is received from the ultimate buyer.

When financing imports, the factor may arrange for the opening of a letter of credit through its bank in favor of an overseas supplier. The factor becomes an intermediary between its customer and the bank, substituting its own credit for that of the client. Because the factor is guaranteeing the letter of credit, the bank is willing to open the credit, which it might not have done for the importer directly.

When the goods are shipped, the title documents are either consigned or endorsed over to the factor. The factor, in turn, releases the documents to the importer against either a trust receipt or warehouse receipt. All proceeds from subsequent sales are turned over to the factor. Once the final sale has been made to a customer approved by the factor, an account receivable is created. The factor, according to its agreement with the customer, buys that receivable without recourse.

When the bank turns over the shipping documents to the factor, arrangements must be made to pay under the sight letter of credit. The factor may pay the bank from its own funds. The goods are cleared through customs and the factor is paid on the average or final maturity date of the accounts receivable, which the factor has bought from its customer without recourse.

Time letters of credit are paid to the bank by the factor at maturity and the resulting acceptances are charged to the customer's account for

payment to the factor when due.

Frequently, instead of making immediate payment under a sight letter of credit, the factor will utilize its credit line with the bank. This option may be taken by either asking the bank to create a banker's acceptance or by charging the factor's loan account. In both instances, the factor must pay the bank at maturity of the acceptance or loan. Such maturities should coincide as closely as possible with the expected payment of the accounts receivable by the ultimate customer.

A factor buying foreign accounts receivables created through open account shipments follows the same basic procedures as in purchasing domestic receivables. As discussed heretofore, the exporter and financing institution could lose control over the goods because the shipping documents are consigned directly to the importer. Consequently, open account shipments should be conducted only with prime foreign buyers.

## Client Records

A client's balance sheet will have a due from factor account instead of accounts receivable. The account balance may be somewhat lower than a normal receivables balance, thus affecting turnover ratios and other short-term ratios. The difference relates to the client's ability to convert sales to cash faster with a factor than if the receivables were to be collected by the client.

Each month, the client receives an accounts current statement from the factor, detailing transactions on a daily basis. 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 also will be shown. Client risk charge-backs are the amounts deducted from the balance due to the client upon the failure of customers to pay receivables factored at client risk. The accounts current statement and the availability sheets are necessary for asset analysis. The accounting system that develops this data probably will be automated, allowing the factor to compare and monitor data on the client. Examiners should use the data provided, within client records, to enhance the asset analysis process for these types of credits.

## Factor Records

The factor's balance sheet reflects the purchased accounts receivable as factored receivables on the asset side and due to clients as the corresponding liability. Usually, the due to clients balance will be less than the factored receivables balance because of payments and advances to the clients. If, however, the factor makes advances to the client for greater amounts than are due to the client, these amounts will be reflected on the asset side of the balance sheet as overadvances. Overadvances are tantamount to unsecured loans. A limit on the amount of overadvances available at any one time to the client should be included in the factoring agreement. Such limitation is generally based upon, but not necessarily secured by, the amount of the client's inventory. This relationship is used because, theoretically, the inventory will be sold to generate receivables that the factor has contracted to purchase. The proceeds from the factored receivables will then be used to repay the overadvance. The factor's income statement will show factoring commissions that 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.

An analysis of the changes in the relative proportions of the due to clients account should provide valuable input into the analysis of the earnings of a branch's factoring operation. Because factoring is a highly competitive industry, price cutting has reduced factoring commissions to a point where they provide minimal support to earnings; therefore, the interest margins on factoring advances have a significant impact on net income. The implication of the analysis of proportional changes is that 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.

## Evaluating the Factoring Operation

The evaluation of a branch's factoring operation includes: (a) a review of its systems and controls, and (b) 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 qual-

ity and collection. The other major portion of the assets will be the client loans and credit accommodations, such as overadvances and amounts advanced at the client's risk, for which the account officers are responsible.

Any factor's ability to buy receivables without recourse is predicated on its ability to make sound credit judgments regarding buyers. The factor, therefore, replaces the credit and, in part, the receivables bookkeeping departments of sellers. The credit department maintains a credit file for each of its client's customers, which are continually updated as purchases are made and paid for by the customers. These files include financial statements, credit bureau reports, and details of purchasing volume and paying habits. Credit information on domestic buyers is easier to obtain than on buyers located overseas. However, by establishing foreign affiliates, factors have improved their ability to determine the credit standing of foreign importers.

## Systems and Controls

Considering the large volume of daily transactions that flows through a factor, any internal control that can be easily negated represents a potential problem. The review of the factoring department's internal systems and controls should be continuous during the examination. This review should include the credit controls for both clients and customers. Credit controls and systems must be responsive to the identification of these problems because problems can develop rapidly in factoring. Earnings are evaluated in terms of the department's own performance. The factoring department's earnings trends may be evaluated by using a comparative yield on assets approach. By analyzing yields on asset categories from period to period, the examiner will be able to make a judgment as to the efficiency of the systems. Factors are subject to the same price competition in the commercial finance market as accounts receivable financiers. Declining portfolio yields may reflect the inroads made by competition and may indicate a decline in future profitability.

## Asset Evaluation

The asset evaluation involves an evaluation of (1) credit accommodations to each client and

(2) customer receivables purchased by the factor at its own risk. For the first part of the evaluation, generate a list of each client's aggregate 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 evaluation, use the aging schedule of factored receivables aggregated by customer but net of client risk receivables. Select clients and customers for review based upon the same selection methods used for the commercial loan review. Clients with high dilution of receivables (i.e., customer nonpayment due to returns, shipping disputes, and errors and the like) and those with client risk receivables equal to 20 percent or more of factored volume may also be included.

### Credit Accommodations to Each Client

In order to evaluate credit accommodations to each client, generate a list of each client's aggregate credit exposure to the factor, both direct and indirect, including overadvances and receivables purchased at the client's risk. Although past due status is an essential element in evaluating customer accounts, it should be noted that for its clients, a factor usually collects principal and interest payments directly from the client's availability. This practice means that the expected delinquency rate is minimal. Past due volume is not an effective measure of client quality.

A 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 other 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 an 80 percent advance client, 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. Loans against this type of collateral may be handled in the commercial finance section of a factoring department.

An analysis of the client's balance sheet should incorporate an assessment of the client's ability to absorb normal dilution and the potential losses associated with client risk receivables, particularly when these elements are higher than usual for the portfolio. The analysis also 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.

When classifying the credit exposure to a client, the client risk receivables portion of factored volume is the only amount appropriate for use in the classification. Because of the recourse aspect, the balance is considered as an indirect obligation rather than a direct obligation. Any other credit accommodations to a client that are not reflected in factored receivables, such as overadvances, term loans, etc., are also appropriate for classification. Asset quality, as measured by classifications, may be influenced by seasonal aspects of clients' businesses and should be carefully analyzed allowing for such influences.

### Customer Receivables Purchased by the Factor at its Own Risk

To evaluate receivables purchased by the factor at its own risk, use the aging schedule of factored receivables aggregated by customer but net of client risk receivables. Select customers for review based upon the same selections methods used for the commercial loan review. Past due volume is an essential element in evaluating customer accounts. In addition, customer files maintained by the factor should include financial statements and an analysis of the customers' financial condition.

When classifying credit exposure to a customer, factored receivables are appropriate for classification. Care should be taken not to classify any receivables that have already been classified under client risk exposure.

### FORFEITING

A number of financial institutions are financing receivables from Eastern European and developing countries by a method called forfeiting.

Forfaiting is nonrecourse financing of receivables similar to factoring. However, while 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 for cash.

The centers of forfaiting are Zurich and Vienna, where many large banks, including American institutions, provide forfaiting through either their branches or specialized subsidiaries.

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 negotiate 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.

The examiner should review the branch's forfaiting activities carefully to determine whether long-term receivables have been purchased from countries prone to frequent political changes and fluctuations in exchange rates. In addition, the other risks peculiar to factoring are present in forfaiting, along with the risks associated with the long-term nature of receivables purchased.

## U.S. AND FOREIGN RECEIVABLES GUARANTEE AND INSURANCE PLANS

To reduce credit, political, and other risks associated with foreign receivables financing, branches 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 of the branch. Nevertheless, the examiner should know the risk coverage and claim adjustment provisions of the major plans. Often a branch's experience with its receivables insurance and guarantee plans indicates its effectiveness and whether the branch has properly met its responsibilities under the programs.

## THE 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 branch purchases from exporters, generally without recourse to the latter. 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 branch without recourse to the exporter normally cannot exceed 90 percent of the financed portion of the sale (invoice amount less cash payment). That 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.

## THE 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, which 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 financial 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 insurers against nonpayment of receivables due to unforeseeable commercial and political occurrences. Commercial risks that are 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 insurance policies covering political and commercial risks (Source: Washington Agencies that Help to Finance Foreign Trade, Seventh Edition, Bankers Trust Company, N.Y.C.):

1. Short-term policies covering shipments normally sold on terms up to 180 days. The usual policy covers 100 percent of political risk and 90 percent of any losses from commercial risk.
2. Minimum-term policies insuring transactions from six months to five years. FCIA covers up to 90 percent of commercial risks and up to 100 percent of political risks, with the remainder retained by the exporter.
3. Combined short-term/medium-term policies for sales that pass through distributors before reaching final buyers.
4. 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 and seldom for medium-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.

## OTHER INSURERS

There are numerous other private and governmental institutions, both in the U.S. and overseas, that guarantee or insure risks assumed by banks financing foreign receivables. Some foreign examples are the Export Credits Guarantee Department (ECGD) in the United Kingdom, COFACE in France, and HERMES in West Germany.

# Financing Foreign Receivables

## Examination Objectives

Effective date July 1997

## Section 3080.2

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1. To determine if the policies, practices, procedures, and internal controls regarding the financing of foreign receivables are adequate.
2. To determine if branch officers are operating in conformance with established branch 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 recommend corrective action when policies, practices, procedures, or internal controls are deficient.

# Financing Foreign Receivables Examination Procedures

Effective date July 1997

## Section 3080.3

1. If selected for implementation, complete or update 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. Obtain a listing of any deficiencies noted in the latest reviews by internal and external auditors from the examiner performing the audit assignment, and determine if appropriate corrections have been made.
4. Obtain the following information for:
  - a. 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 branch's past experience in dealing with the borrower who sells on open account.
  - b. 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 warehouse.
    - Any arrangements that have been made whereby the selling agent negotiates for the sale of the goods.
  - c. Advances Against Collections:
    - The regulations in the country of destination regarding the return of unsold consigned goods to the country of origin.
    - The branch's past experience in dealing with the borrower who sells on consignment.
    - 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 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 branch's experience in dealing with the borrower who receives advances against collections.
  - d. 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 branch discounted the trade acceptance with or without recourse.
    - Whether the borrower retains a percentage of the trade acceptance endorsed to the branch.
    - 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 branch's experience in dealing with the borrower for whom its trade acceptances are discounted by the branch.
- e. 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 branch'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 branch's experience in dealing with the borrower.
- f. Factoring:
- The extent of factor guarantees (letters of credit opened by the branch 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 banker's acceptances are charged to the branch customer's account for payment to the factor when due.
  - Whether the factor 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 branch opened the letter of credit.
  - Any disputes, nonacceptance of goods, and possession of goods without payment.
  - The branch's experience in dealing with the factor.
- g. Forfaiting:
- Agings of debtor accounts purchased.
  - Ineligible debtor accounts purchased, including affiliate receivables, if any.
  - Concentration of debtor accounts purchased.
  - The adequacy of the branch'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 branch's experience in dealing with both the debtors and the exporter.
- h. U.S. and foreign receivables guarantee and insurance plans:
- Whether foreign receivables coverage by FCIA, Eximbank, or other insurance or guarantee programs is sufficient, adequately identifies risks, and is consistent with established limits.
5. Analyze secondary support offered by guarantors and endorsers.

6. Determine compliance with the branch's established loan policy.
7. At this point, the examiner needs to decide whether further examination and testing is needed. If further work is warranted, refer to the audit guidelines. After reviewing the audit guidelines, proceed to step 8.
8. 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. Other matters regarding the condition of the department.
9. Evaluate the branch with respect to:
  - a. The adequacy of written policies relating to financing foreign receivables.
  - b. The manner in which branch officers are operating in conformance with established policy.
  - c. Adverse trends in those sections concerned with financing foreign receivables.
  - d. Recommended corrective action when policies, practices, or procedures are deficient.
  - e. The competency of departmental management,
  - f. Other matters of significance.
10. Update the workpapers with any information that will facilitate future examinations.

# Financing Foreign Receivables Internal Control Questionnaire

Effective date July 1997

## Section 3080.4

### POLICIES

1. Has the head office adopted 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 policies reviewed at least annually to determine if they are compatible with changing market conditions?

### ACCOUNTING RECORDS

*If the following questions have been answered in the Credit Risk section (3010), skip to question 9.*

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 are reconciling items adequately investigated by persons who do not normally handle foreign receivables financing?
5. Are inquiries regarding loan balances for foreign receivables financing 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

*If the following questions have been answered in the Credit Risk section (3010), skip to question 14.*

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 branch record a first lien on assigned foreign receivables for each borrower on a timely basis?
15. Do loans granted on the security of the foreign receivables also have an assignment of the inventory?
16. Does the branch verify the borrower's receivables or require independent verification on a periodic basis?

17. Does the branch 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 branch rather than the foreign buyer?
19. Are the shipments being financed covered by adequate insurance?
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 follow-up procedures been established for sending tracers and inquiries on unpaid collections in the hands of correspondents?

### ADVANCES AGAINST COLLECTIONS AND DISCOUNTED TRADE ACCEPTANCES

20. Are permanent registers kept for foreign collections against which advances were made or trade acceptances were 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 were 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 that 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 branch 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?
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 nonpayment of the collection, is the borrower promptly notified by the branch?
37. Are collections against which advances have been made or trade acceptances discounted distinctly segregated from ordinary collection items?
38. Are financed collections 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 branch properly surrendered the shipping documents to the factor either through endorsement or consignment?
44. Do advances or banker's acceptances coincide with the expected payment of the accounts receivable by the ultimate customer?

**FOREIGN CREDIT INSURANCE  
ASSOCIATION INSURANCE**

45. Is the branch aware of risks not covered under its assigned FCIA insurance?
46. Does the branch monitor whether the borrower exceeded its FCIA established credit limits?
47. Does the branch monitor whether the borrower properly assigned the proceeds of its FCIA insurance to the branch?
48. Is the branch aware of whether the FCIA insurance is on either simple notice or a special assignment basis?
49. Does the branch retain recourse to the exporter under its FCIA arrangement?
50. Has the branch reported delinquencies to FCIA in accordance with its agreement with the Association?
51. If default occurs, does the branch file a proper claim with FCIA?
53. If the branch has discretionary authority from Eximbank, does it nevertheless inform Eximbank of each transaction thereunder?
54. If the branch 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 branch monitor whether loan agreements between applicable borrowers and the branch are acceptable to Eximbank?
56. Does the branch report delinquencies to Eximbank in a timely manner, as specified in its agreement with that agency?
57. If default occurs, does the branch file a proper claim with Eximbank?

**EXPORT-IMPORT BANK OF THE  
UNITED STATES**

52. Does the branch, financing under Eximbank arrangements, have properly executed Eximbank guarantees or commitments covering transactions?
58. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
59. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

**CONCLUSION**

# Financing Foreign Receivables

## Audit Guidelines

Effective date July 1997

## Section 3080.5

1. Test the addition of trial balances and their reconciliation to the general ledger. Include loan commitments and other contingent liabilities.
2. If memoranda controls are maintained, prepare a trial balance of each account so controlled. Using an appropriate sampling technique, select representative items and:
  - a. Review all supporting documents.
  - b. Verify the authenticity of each item selected and trace and clear each item through final payment, including appropriate credit to the customer's account.
  - c. In the case of unusual, altered, or long-standing items, prepare and mail confirmation requests to customers.
  - d. Examine financing instruments for completeness and verify dates, amounts, and items to the trial balance.
  - e. Check to see that financing instruments are signed, appear to be genuine, and are negotiable.
  - f. Check to see that required initials of an approved lending officer are on the financing instrument.
  - g. Determine that the amount is within the officer's lending limit.
  - h. Determine that any necessary insurance coverage is adequate and that the branch is named as loss payee.
  - i. Review disbursement ledgers and authorizations to determine if:
    - Authorizations are signed in accordance with the terms of the loan agreement.
    - Collection funds received are credits in accordance with provisions of the borrower's loan agreement.
  - j. Determine that records are posted promptly on collections settled, preferably on the same day they are received.
3. Review the applicable accrued interest accounts by:
  - a. Reviewing and testing procedures of accounting for accrued interest and for handling adjustments.
  - b. Scanning accrued interest for any unusual entries and following up on any unusual items by tracing them to initial and supporting records.
  - c. Independently calculating for those credit extensions selected in step 2, the amount of accrued interest and confirming the amount to the detail of accrued interest receivable for that loan.
4. Using a list of nonaccruing loans, check accrual records to determine that interest income is not being recorded.
5. Test appropriate records to determine that discount, commissions, fees, and collection charges are in accordance with established amounts and that the income accounts are properly credited.
6. Obtain or prepare a schedule showing the monthly interest income amounts and applicable loan balances at each month-end since the last audit and:
  - a. Calculate yield.
  - b. Investigate significant fluctuations and trends.

A branch's authority to hold real estate rests with the laws of its respective state (if state licensed) or the National Banking Act (if federally licensed). State and federal laws and regulations may dictate accounting procedures, maximum holding periods, and other details relating to other real estate owned. Examiners should follow the most recent interagency guidelines when verifying the proper identification, reporting, valuation, and accounting for disposal of other real estate owned (OREO).

Relevant interagency joint statements include "Interagency Guidance on Accounting for Dispositions of Other Real Estate Owned," dated July 16, 1993, and "Interagency Guidance on Reporting of In-Substance Foreclosures," dated June 10, 1993. In addition, refer to the final rule entitled "Real Estate Lending Standards," promulgated by the Federal Reserve Board, FDIC, OTS, and OCC in December 1992. See Final Rule, 57 Fed. Reg. 62890 (December 31, 1992). The various state and federal agencies may differ in terms of specific practices and methodologies used to implement the above guidelines. For further guidance in this area, examiners should consult with their respective agencies.

Real property becomes other real estate owned through:

- Conveyance in satisfaction of debts previously contracted;
- Exchange for future advances to an existing borrower to fully or partially satisfy debts previously contracted;
- Purchase to secure debts previously contracted;
- Relocation of branch premises; or
- Abandonment of plans to use real estate acquired for future expansion for banking premises.

Although the borrower may still retain possession and legal title to the property, certain troubled loans secured by real estate are considered to be "insubstance foreclosures" and are also treated as other real estate owned. An insubstance foreclosure situation is generally characterized by a borrower with little or no equity and the sale of the property is the only source of repayment.

## ENVIRONMENTAL LIABILITY

Under federal and state environmental liability statutes, a branch may be liable for cleaning up hazardous substance contamination of other real estate owned. In some cases, the liability may arise before the branch takes title to a borrower's collateral real estate. A property's transition from collateral to branch ownership may take an extended period of time. As the financial problems facing a borrower worsen, a branch may become more involved in managing a company or property. Such involvement may become extensive enough that the branch is deemed to have met substantially all ownership criteria, the absence of a clear title in the branch's name notwithstanding. Generally, the more involved branch management is in such activity, the greater the branch'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 the Real Estate Loans section of this manual.

## TRANSFER OF ASSETS TO OTHER REAL ESTATE OWNED

Real estate assets transferred to OREO should be accounted for individually on the date of transfer, at the lower of the recorded investment in the loan or fair value. The recorded investment in a loan is the unpaid balance, increased by accrued and uncollected interest, unamortized premium, finance charges, and loan-acquisition costs, if any, and decreased by previous write-downs and unamortized discount, if any. Any excess of the recorded investment in the loan over the property's fair value must be charged against the allowance for loan and lease losses immediately upon the property's transfer to OREO. Legal fees should generally be charged to expenses unless payment of the fees is for the purpose of enhancing the property's value (for example, obtaining a zoning variance).

Establishing a valuation allowance for estimated selling expenses may also be necessary upon transferring each property to OREO to comply with AICPA Statement of Position 92-3, Accounting for Foreclosed Assets. According to this pronouncement, the value of OREO properties must be reported at the lesser of the fair

value minus estimated selling expenses or the recorded investment in the loan. For example, if the recorded investment of the property is \$125, the fair value is \$100, and the estimated selling expenses are \$6, the carrying value for this property would be \$94. The difference between the recorded investment and the fair value (\$25) would be charged to the allowance for loan and lease losses at the time the property was transferred to OREO. In addition, since the branch estimated it would incur selling expenses of \$6, a valuation reserve for this amount must be established. The net of the fair value and this valuation reserve for selling expenses is called the “net realizable value,” and in this example would be \$94. Changes to this valuation reserve should be handled as outlined in the subsection “Accounting for Subsequent Changes in Market Value.”

On the other hand, if the recorded investment in the property is \$250, the fair value is \$300, and the estimated selling expenses are \$18, the carrying value of this property would be \$250 (the lesser of the recorded investment or the fair value). In this example, a valuation reserve for estimated selling expenses is unnecessary, as netting the estimated selling expenses (\$18) from the fair value (\$300) would yield a net realizable value of \$282.

The transfer of 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 branch 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 branch may elect, but is not required, to obtain an appraisal to serve as the “appropriate evaluation.” Until the evaluation is available, a branch 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 Real Estate Loans section of this manual for a definition of market value. Generally, market value and fair value are equivalent when an active market exists for a property. In discussing

OREO, it is common practice to use the terms “fair value” and “market value” interchangeably. When no active market exists for a property, the accounting industry’s definition of fair value applies because the appraiser cannot determine a market value. The accounting industry definition requires the appraisal or evaluation to contain an estimate of the property’s fair value based on a forecast of expected cash flows, discounted at a rate 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 value.

When a branch acquires a property through foreclosure as a junior lienholder, whether or not the first lien has been assumed, the fair value of the property should be recorded as an asset and the senior debt as a liability. The senior debt should not be netted against the assets. Any excess of the recorded investment of the property over the fair value should be charged off, as the recorded investment may not exceed the sum of the junior and senior debt. Payments made on senior debt should be accounted for by reducing both the asset and the liability, and interest that accrues on the senior debt after foreclosure should be recognized as interest expense.

For regulatory reporting purposes, a collateral-dependent real estate loan should be transferred to OREO only when the lender has taken possession (title) of the collateral. Nevertheless, to facilitate administration and tracking, branches may choose to include a collateral-dependent real estate loan in the OREO portfolio as potential or probable OREO. Examiners should review these loans using the same criteria applied to OREO.

## CARRYING VALUE OF OTHER REAL ESTATE OWNED

A branch 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 branch should reappraise or reevaluate its OREO property, the branch’s policy should conform to state or

federal law, if applicable, and address the volatility of the local real estate market. Specifically, a branch should determine if 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 branch should obtain a new appraisal or evaluation based on assumptions that reflect the changed conditions.

## ACCOUNTING FOR SUBSEQUENT CHANGES IN MARKET VALUE

Charges for subsequent declines in the fair value of OREO property should never be posted to the allowance for loan and lease losses. If an appraisal or evaluation indicates a subsequent decline in the fair value of an OREO property, the loss in value should be recognized by a charge to earnings. Branches should attempt to determine whether a property's decline in value is temporary or permanent, taking into consideration each property's characteristics and existing market dynamics. The preferred treatment for permanent 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 reserve 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 OREO Property Value

Assume a branch has written down its initial recorded investment in an OREO property from \$125 to its fair value of \$100. Since the fair value of the property was less than the initial recorded investment, a valuation reserve for estimated selling expenses was established. In this example, assume these to be \$6. Accordingly, the net realizable value was \$94 (\$100 minus \$6). Next, assume a new appraisal indicates a fair value of \$90, reducing the estimated selling expenses to \$5. Although the branch must expense the depreciation in the fair value (\$10), the valuation reserve for selling expenses would be reduced by the difference in the estimate of the selling expenses (\$1). Given this scenario, the "adjusted" net realizable value would be \$85 (\$90 minus \$5).

## Appreciation in OREO Property Value

Assume a branch has written down its recorded investment in an OREO property to its fair value of \$100. Since the fair value of the property was less than the original recorded investment, an estimated valuation reserve for selling expenses of \$6 was established. Accordingly, the net realizable value was \$94. A new appraisal indicates an increase in the fair value of the property to \$110, with selling expenses now estimated at \$7. As a result, the net realizable value is now \$103. Given that the new net realizable value is greater than the recorded investment of \$100, the selling expense valuation reserve is no longer necessary and the \$6 can be reversed to income. Notwithstanding the property's increased fair value, the recorded investment value cannot be increased above \$100. The valuation reserve for selling expenses can never be less than zero, thus prohibiting an increase in the value of the property above the recorded investment.

## ACCOUNTING FOR INCOME AND EXPENSE

Gross revenue from other real estate owned 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 branch 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 branch'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 branch'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.

## DISPOSITION OF OTHER REAL ESTATE OWNED

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. Branches 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 branch 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 branch 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 branch, except for real estate that has become OREO because the branch 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 branch should determine whether such requirements exist and comply with them.

## ACCOUNTING FOR THE SALE OF OTHER REAL ESTATE OWNED

Gains and losses resulting from a sale of OREO properties for cash must be recognized immediately. A gain resulting from a sale in which the branch provides financing should be accounted for under the standards described in Statement of Financial Accounting Standards 66 (SFAS 66).

SFAS 66 recognizes that differences in terms of the sale and in selling procedures lead to different profit recognition criteria and methods. Branches may facilitate the sale of foreclosed real estate by requiring little or no down payment, or by offering loans with favorable terms. Profit shall only be recognized in full when the collectibility of the sales price is reasonably ensured and when the seller is not obligated to perform significant activities after the sale to earn the profit. Unless both conditions exist, recognition of all or part of the profit shall be deferred. Collectibility of the sale price of OREO property is demonstrated when the buyer's investment is sufficient to assure that the buyer will be motivated to honor his or her obligation to the seller rather than lose the investment. Collectibility shall also be assessed by considering factors such as the credit standing of the buyer, age and location of the property, and adequacy of cash flow from the property.

The practice of recognizing all profit from the sale of branch-financed OREO at the time of the sale is referred to as the full-accrual method. A branch shall not recognize profit using this method until all of the following general criteria are met:

- A sale is consummated.
- The buyer's initial and continuing investments adequately demonstrate a commitment to pay for the property.
- The branch's loan is not subject to future subordination.

- The branch has transferred to the buyer the usual risks and rewards of ownership in a transaction that is in substance a sale, and it has no substantial continuing involvement in the property.

A sale will not be considered consummated until the parties are bound by the terms of the contract, all consideration has been exchanged, and all conditions precedent to closing have been performed.

Initial investment, as defined by SFAS 66, includes only cash down payments, notes supported by irrevocable letters of credit from an independent lending institution, payments by the buyer to third parties to reduce existing debt on the property, and other amounts paid by the buyer that are part of the sale price. In these situations, SFAS 66 requires that profit on the sale be deferred until a minimum down payment has been received and annual payments equal those for a loan for a similar type of property with a customary amortization period. The amount of down payment required varies by category of property: land, 20–25 percent; commercial and industrial, 10–25 percent; multifamily residential, 10–25 percent; and single-family residential, 5–10 percent. Ranges within these categories are defined further in the statement.

Continuing investment requires the buyer to be contractually obligated to make level annual payments on his or her total debt for the purchase price of the property. This level annual payment must be able to service principal and interest payments amortized for no more than 20 years for raw land, and for no more than the customary amortization term for a first-mortgage loan by an independent lending institution for other types of real estate.

If a branch finances the sale of foreclosed property it owns with a loan at less than current market interest rates or noncustomary amortization terms, generally accepted accounting principles require that the loan be discounted to bring its yield to a market rate, using a customary amortization schedule. This discount will either increase the loss or reduce the gain resulting from the transaction. Interest income is then generally recognized at a constant yield over the life of the loan.

If a transaction does not qualify for the full-accrual accounting method, SFAS 66 identifies alternative methods of accounting for sales of OREO property as described below.

## The Installment Method

This method is used when the buyer's down payment is insufficient to allow the full-accrual method, but when recovery of the cost of the property is reasonably assured if the buyer defaults. The installment method recognizes the sale of the property and the booking of the corresponding loan, although profits from the sale are recognized only as the branch receives payments from the buyer. Under this method, interest income is recognized on an accrual basis, when appropriate.

Since default on the loan usually results in the seller (the branch) reacquiring the real estate, the branch is reasonably assured that it will be able to recover its costs with a relatively small down payment. Cost recovery is especially likely when loans are made to buyers who have verifiable net worth, liquid assets, and income levels adequate to service the loan. Reasonable assurance of cost recovery also may be achieved when the buyer pledges adequate additional collateral.

## The Cost-Recovery Method

Dispositions of OREO that do not qualify for either the full-accrual or installment methods are sometimes accounted for using the cost-recovery method. This method recognizes the sale of the property and the booking of the corresponding loan, but all income recognition is deferred. Principal payments are applied by reducing the loan balance, and interest payments are accounted for by increasing the unrecognized gross profit. No profit or interest income is recognized until either the buyer's aggregate payments exceed the recorded amount of the loan or a change to another accounting method (for example, the installment method) is appropriate. Consequently, the loan is maintained on nonaccrual status while this method is being used.

## The Reduced Profit Method

This method is used in certain situations when the branch receives an adequate down payment, but the loan amortization schedule does not meet the requirements for use of the full-accrual method. The branch again recognizes the sale of the property and the booking of the corresponding loan but, as under the installment method,

profits from the sale are recognized only as the branch receives payments from the buyer. Since sales with adequate down payments generally are not structured with inadequate loan-amortization schedules, this method is seldom used.

## The Deposit Method

This method is used when a sale of OREO has not been consummated. It also may be used for dispositions that could be accounted for under the cost-recovery method. Under this method, a sale is not recorded, so the asset continues to be reported as OREO. Further, no profit or interest income is recognized. Payments received from the buyer are reported as a liability until the use of one of the other methods is appropriate.

Branches 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 branch employs for its regular lending activity. Financing arrangements associated with this type of transaction are subject to the accounting treatment discussed above.

Branch records should (1) indicate the accounting method used for each sale of OREO, (2) support the choice of the method selected, and (3) sufficiently document that the institution is correctly reporting associated notes receivable, as either loans or OREO property, with valuation allowances as appropriate.

## CLASSIFICATION OF OTHER REAL ESTATE OWNED

The examiner should generally evaluate the quality of each OREO property to determine if classification is appropriate. OREO usually should be considered a problem asset, even when it is carried at or below its appraised value. Despite the apparent adequacy of the fair or market value, the branch's acquisition of OREO through foreclosure usually indicates a lack of demand. As time passes, the lack of demand can become more apparent, and the value of the real estate can become increasingly questionable.

When evaluating the OREO property for classification purposes, the examiner must consider the property's market value, whether it is being held in conformance with state law, and whether it is being disposed of according to the branch'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. The examiner should review all types of OREO for classification purposes, including sales that fail to meet the standards required for the full-accrual method of accounting. When the branch provides financing, the examiner should determine whether it 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 market value (including the date of any appraisal or evaluation relative to changes in market conditions), the branch'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;
- Branch 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 branch intends to dispose of the property; and
- 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.

# Other Real Estate Owned

## Examination Objectives

Effective date July 1997

## Section 3090.2

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1. To determine if the policies, practices, procedures, and internal controls regarding other real estate owned are adequate.
2. To determine that branch officers and employees are operating in conformance with the established guidelines.
3. To verify the carrying value of all other real estate owned.
4. To determine the scope and adequacy of the internal/external audit function.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Other Real Estate Owned

## Examination Procedures

Effective date July 1997

## Section 3090.3

1. If included in the scope of the examination, complete or update the Internal Control Questionnaire.
2. Test for compliance with policies, practices, procedures, and internal controls in conjunction with performing the remaining examination procedures. Obtain a listing of any audit deficiencies noted in the latest review by internal/external auditors, and determine if appropriate corrections have been made.
3. Obtain a list of other real estate owned and reconcile the total to the 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 branch accepted written bids for the property.
    - The bids are maintained on file.
    - There is justification for accepting a lower bid if the branch 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 or federal laws and regulations.
  - b. Determine if other real estate is being amortized or written off in compliance with applicable state or federal laws and regulations.
  - c. Consult with the examiners assigned to “Loan Portfolio Management,” “Other Assets (and Other Liabilities),” and “Bank Premises and Equipment” to determine:
    - If the branch holds real estate acquired as salvage on uncollectible loans, abandoned bank premises, or property originally purchased for future expansion but which is no longer intended for such usage.
    - If troubled real estate loans meeting the criteria for in-substance foreclosures and covered transactions are identified.
    - If covered transactions and in-substance foreclosures are being properly accounted for and reported as other real estate owned.
- 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 branch’s persistent and diligent effort to dispose of the property.
  - If the branch 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 its abandonment.
  - Such property is disposed of in accordance with state or federal laws and regulations, including Regulation Y.
  - The valuation is not affected by an Environmental Protection Agency issue.
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 and when real estate was acquired.
  - c. Amount and date of appraisal.
  - d. Amount of any offers and branch’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 noncompliance 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.

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**OTHER REAL ESTATE OWNED  
RECORDS**

1. Are postings to the general ledger account for other real estate owned approved and/or tested, prior to posting, by persons who do not have direct, physical, or accounting control of those assets?
2. Are the subsidiary records for other real estate owned balanced at least quarterly to the appropriate general ledger accounts by persons who do not have direct, physical, or accounting control of those assets?
3. Are supporting documents maintained for all entries to other real estate owned accounts?
4. Are acquisitions and disposals of other real estate owned reported to senior management at the head office?
5. Does the branch maintain insurance coverage on other real estate owned, including liability coverage where necessary?
6. 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?

- e. Anticipated methods for disposal of property?
- f. Changes in tax status, zoning restrictions, other liens, etc.?

**OTHER PROCEDURES**

7. Does the branch have written policies and procedures relating to other real estate owned?
8. Does the branch factor in Environmental Protection Agency issues and their impact on valuation into its policies?

**CONCLUSION**

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

# Other Real Estate Owned

## Audit Guidelines

Effective date July 1997

## Section 3090.5

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1. Test the additions of the subsidiary ledgers and reconcile the total to the general ledger. Include insubstance foreclosures and property sold in "covered transactions."
2. Using appropriate sampling techniques, select specific properties and determine that:
  - a. Legal title to the property is obtained when the asset is recorded as other real estate owned.
  - b. Legal fees and direct costs of acquiring title, including payment of existing liens, taxes, and recording fees are expensed when incurred and are not capitalized.
  - c. Insurance, including liability coverage, is adequate and the branch is named as loss payee.
3. Using appropriate sampling techniques, select specific properties, and for expenses incurred in maintaining the properties or capitalized costs of improvement and development:
  - a. Trace the transaction to any previous records and to postings in the general ledger.
  - b. Examine documentation supporting the transaction and prove any computations reflected on the supporting document.

Real estate lending is a major function of some branches. However, the composition of real estate loan portfolios will vary from branch to branch because of differences in strategic direction, asset size, lending experience, market conditions, and location. This section of the manual deals with the permanent financing of residential and commercial real estate. Also included in this section are discussions on real estate appraisals and environmental liability. Real estate construction lending is discussed separately in the following section of this manual.

Due to the differences in individual state banking laws, this section of the manual provides a general overview of the supervisory and regulatory requirements for a safe and sound real estate lending program. For information on lending limitations and restrictions, refer to the applicable banking laws and regulations that govern federally-insured and state-licensed branches.

### REAL ESTATE LENDING POLICY

The branch's real estate lending policy is a broad statement of the standards, guidelines, and limitations that senior branch management and lending officers are expected to adhere to in the process of 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 branch's management of the real estate lending function.

The policies governing a branch's real estate lending activities must include prudent underwriting standards that are periodically reviewed by head office management and clearly communicated to the branch's management and lending staff. The branch should also have credit risk control procedures that include, for example, prudent internal limits on exposure and an effective credit review and problem loan identification process. The complexity and scope of these policies and procedures should be appropriate to the size of the branch and the nature of the branch's activities, and should be consistent with prudent banking practices and relevant regulatory requirements. As part of the analysis of a branch's real estate loan portfolio, examiners should review lending policies, loan admin-

istration procedures, and credit risk control procedures as well as the branch's compliance with its policy.

On March 19, 1993, a uniform rule on real estate lending by insured depository institutions promulgated by the federal banking agencies became effective. Although the rule does not directly apply to uninsured branches, it should be used as a general supervisory guide when reviewing loan portfolios, procedures, and practices at all branches. The rule requires each insured depository institution to adopt and maintain comprehensive written real estate lending policies that are consistent with safe and sound banking practices, are appropriate to the size of the institution, and the nature and scope of its operations. The policies must establish loan-to-value limits; loan administration procedures; portfolio diversification standards; and documentation, approval, and reporting requirements. The policies adopted by the branch should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies established by the federal banking agencies. In addition to the requirements of the uniform rule, a branch's real estate lending policy should include principal amortization terms acceptable for each type of real estate loan that the branch underwrites. Branch management should also ensure that loans are granted with the reasonable expectation that the borrowers will be able and willing to meet the repayment terms. Any loan that does not follow this principle should be regarded as an unsound banking practice, regardless of the collateral value and favorable ratio of collateral value to the outstanding loan. While there is no single lending policy appropriate for all branches, there are basic elements that a branch should consider in formulating its policy, including:

- Allocation of funds (i.e., maximum exposure) for real estate lending;
- Definition of acceptable loans that the branch would consider making and the minimum terms that are acceptable to the branch (i.e., amortization rates and cash flow coverage ratio by loan type);
- Geographic area in which the branch will consider lending;
- Minimum standards for credit analysis and loan documentation, including real estate appraisal and evaluation policies;

- Minimum credit criteria that a borrower must meet for the credit to be considered by the branch;
- Maximum loan amounts and loan maturities that can be extended on a given property type;
- Maximum aggregate loan amounts that may be extended for a given category of real estate loans and for all other real estate loans;
- Required pricing structure for each type of loan;
- Definition of lending authorities and loan approval process;
- Structure and procedures for administering the disbursement and servicing of the branch's real estate loan portfolio;
- System for monitoring troubled loans;
- Regular review of procedures and practices to ensure compliance with the branch's lending policy and safe and sound lending practices; and
- Procedures for originating and purchasing loans with loan-to-value ratios in excess of those limits discussed in the Interagency Guidelines for Real Estate Lending Policies, based on the support provided by other credit factors.

## REAL ESTATE LENDING ACTIVITY AND RISKS

Real estate lending falls into two broad categories: short-term financing (i.e., construction loans) and permanent financing (e.g., a 30-year residential mortgage or 10-year balloon mortgage on an existing commercial office building). Each type of lending carries with it unique underwriting risks and common risks associated with any type of lending. In all cases, the branch should understand the credit risks and structure of the proposed transaction, even if it is not the originating lender. This policy includes, at a minimum, evaluating the financial strength of the borrower to repay the debt and the value of the underlying real estate collateral.

Permanent financing, as the name implies, is long-term in nature and presents a funding risk because a branch's source of funds is generally of a shorter maturity. Accordingly, branch 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 branch's overall loan portfolio management, the importance of

this task is even more evident in real estate lending activity. Many institutions reduce their funding risk by entering into loan participations and sales with other institutions and asset securitization transactions.<sup>1</sup>

For a detailed discussion on short-term financing, see the manual section on Real Estate Construction Loans.

## UN SOUND LENDING PRACTICES

Some institutions 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 institution'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 relation to normal lending practice for a similar type of property. Other unsafe and unsound lending practices include the failure of the institution to examine the borrower's debt service ability, or inappropriate loan structure such as capitalizing interest on a term loan, not requiring principal amortization, or "ever-green" lending—i.e. extending a short-term loan for long-term purposes. 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 branch should have in place effective internal policies, systems, and controls to monitor and manage its real estate loan portfolio risk. An indication of improper management of a branch's portfolio is an excessive concentration in loans

1. See the section on Asset Securitization for additional information, including information on mortgage-backed securities (MBSs), collateralized mortgage obligations (CMOs), and real estate mortgage investment conduits (REMICs).

to one borrower or related borrowers, in one type of real estate loan, or in a geographic location outside the branch's designated trade area. In the case of a branch, examiners should base their initial review of asset concentrations on the total assets of the branch. (See the Credit Risk Management section for further information on branch concentrations.)

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. Institutions with asset concentrations should have effective internal policies, systems, and controls in place to monitor and manage this risk.

Concentrations that involve excessive or undue risks require close scrutiny by the branch and head office management, and should be reduced over a reasonable period of time. To reduce this risk, the branch should develop a prudent plan and institute strong underwriting standards and loan administration to control the risks associated with new loans.

## 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 branch'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 pay-offs*—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 branch 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 branch 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 branch's security interests in the public land records.

Some institutions provide various levels of loan services for other institutions, which may range from the distribution of payments received to the ultimate collection of the debt through foreclosure. In such cases, the branch 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, time frame for remitting funds, and fee structure. If one institution relies upon another institution for servicing, the branch should have adequate control and audit procedures to verify the performance of the servicer (also see the manual section on Asset Securitization). For residential loans sold into the secondary mortgage market for which the branch has retained servicing, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation

(FHLMC), and the Government National Mortgage Corporation (GNMA) have specific standards to which the branch (i.e., seller/servicer) must adhere. Failure to meet these standards can result in the termination of the servicing agreement.

## ASSESSMENT OF THE BORROWER

While the value of the real estate collateral is an important component of the loan approval process, the branch should not place undue reliance upon the collateral value in lieu of an adequate assessment of the borrower's ability to repay the loan. These assessment factors will differ depending upon the purpose of the loan, such as single family residential loans compared to 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 branch's assessment of the borrower and contain the appropriate legal documentation to protect the branch's interests.

### Single Family Residential Loans

Some branches make single family residential loans, typically to branch employees. As with other such loans, the branch should evaluate the applicant's creditworthiness and determine whether the individual has the ability to meet monthly mortgage payments and meet all other obligations and expenses associated with home ownership. This process includes an assessment of the applicant's income, liquid assets, employment history, credit history, and existing obligations.<sup>2</sup> The branch 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.

2. There are restrictions on the information that federally-insured branches 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; and Regulation Z, Truth in Lending (12 CFR 226), describes the disclosure requirements to the potential borrower on the cost of financing.

If a branch delegates the loan origination function to a third party, the branch 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 branch and the third-party originator to set forth the responsibilities of the third party as an agent for the branch; a periodic review of the third party's operations to ensure that the branch's policies and procedures are being followed; and development of quality controls to ensure that loans originated by the third party meet the branch's lending standards and those of the secondary mortgage market, if the branch expects to sell the mortgages.

### Secondary Residential Mortgage Market

In the secondary market, a branch (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 branch 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: FNMA,<sup>3</sup> FHLMC,<sup>4</sup> and GNMA.<sup>5</sup> These entities were created or sponsored by the federal government to encourage the financing and construction of residential housing. FNMA, FHLMC, and GNMA have specific underwriting standards and loan documentation requirements for mortgages, which they purchase or guarantee.

3. Although FNMA 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 GNMA. Financial institutions can either sell mortgages directly to FNMA or pool mortgages for placement in a FNMA-guaranteed mortgage-backed security.

4. FHLMC 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.

5. GNMA, a government agency under the Department of Housing and Urban Development (HUD), was created in 1968 when FNMA 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, GNMA acts as a guarantor of mortgage-backed securities for pools of loans originated and securitized by financial institutions.

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 branch's experience. In considering an application for a commercial real estate loan, a branch 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 financial resources available for the completion of the project and the management and repayment of the loan.

Information on past and current projects constructed, rented, or managed by the potential borrower can help the branch assess the borrower's experience and the likelihood of the proposed project's success. For development and construction projects, the branch 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 branch 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 branch 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,<sup>6</sup> the branch should quantify the degree of protection from the borrower's (or collateral's) cash flow, the value of the underlying collateral, and any guarantees or other collateral that may be available as a source of loan repayment.

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6. Income-producing commercial properties include rental apartments, retail properties, office buildings, warehouses, and hotels.

## ASSESSMENT OF THE REAL ESTATE COLLATERAL

Branches should obtain an appraisal or evaluation, as required by any applicable federal or state laws or regulations, for all real estate-related financial transactions, before making the final credit or other decision. (Refer to the Real Estate Appraisals and Evaluations part of this section for additional information.) The appraisal section explains the standards for appraisals, indicates which transactions should have an appraisal or an evaluation, provides guidelines on qualifications for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal approaches for a Complete Appraisal.

Management is responsible for determining whether the assumptions and conclusions of the appraisal or evaluation are reasonable. In addition, 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 branch 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 the residential property's market value is critical to the branch's estimate of loan-to-value ratio. This assessment provides the branch with an estimate of the borrower's equity in the property and the branch's potential credit risk, if the borrower should default on the loan. While transactions under \$250,000 may not require an appraisal, a branch is expected to perform an appropriate evaluation of the underlying real estate collateral. Additionally, state laws for appraisals may differ from federal regulatory or internal requirements.

## Commercial Real Estate Loans

Due to the variety of uses and the complexity of most commercial projects, there is no uniformly

accepted format for valuing commercial properties as there is for valuing one-to-four family residential properties. A branch relies upon 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 on the income approach to valuation to a greater degree 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 branch 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 determine 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 branch 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 compared to budget projections; and,
- Discount rates and direct capitalization rates.

Because the income approach is generally relied upon to a greater degree than the other methods, with specific emphasis on arriving at stabilized values, the branch 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, branches should be alert for economic indicators of weakness in their real estate markets and for indicators of actual or potential problems in the individual commercial real estate projects. Available indicators, which may be 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; and,
- 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 on speculative, undeveloped property where the borrower's only source of repayment is the sale of the developed 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<sup>7</sup>;
- Evergreen loans—short-term, interest-only loans that are renewed annually with no provision for repayment. Although structured as a short-term loan, these loans are intended for long-term purposes such as for the acquisition or development of real estate;
- Loans that continue to capitalize interest after construction is completed because of slower than anticipated lease-up;
- Loans with no meaningful principal amortization, instead relying on price appreciation and the sale of property for repayment; and,
- Loans that are funded before zoning is obtained, water rights acquired, or an environmental study is performed.

## EXAMINER REVIEW OF COLLATERAL VALUE

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

7. As discussed more fully in the section on Asset Quality Classifications, 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. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

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.<sup>8</sup> 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.

An examiner's analysis of the collateral value is based on the branch's most recent appraisal or evaluation and includes a review of the major facts, assumptions and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal or evaluation.

Examiners should not make adjustments to appraisal or evaluation assumptions for credit analysis purposes based on worst-case scenarios that are unlikely to occur. For example, examiners 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 should be given a reasonable amount of deference when recently made by qualified appraisers or qualified evaluators and when consistent with the discussion above. 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. In analyzing loans, 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. However, the fact that the underlying collateral value equals or exceeds the current loan balance, does not preclude the loan from classification if other factors jeopardize the repayment ability of the borrower, such as the lack of credible financial support for full repayment from reliable sources.

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 classified or categorized as special mention, unless well-defined weaknesses exist that jeopardize repayment. A branch should not be criticized for working with borrowers whose loans are classified or categorized as special mention, as long as the branch has a well-conceived and effective workout plan for such borrowers and effective internal controls to manage the level of these loans.

In evaluating real estate credits for possible classification, examiners should apply the standard classification definitions as set forth in the Classification of Credits section of the manual. In determining the appropriate classification, 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.

The loan's performance history to date is important and must be considered by the examiner. 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. However, it would be appropriate to classify a

8. 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, examiners 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 the Asset Quality Classifications section of this manual.

performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.<sup>9</sup>

These classification 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.

### 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, this methodology would occur infrequently.

9. Another issue that arises in the review of commercial real estate loans 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 Report of Assets and Liabilities (call report) and in related supervisory guidance of the banking regulatory agencies. This guidance is summarized in the Credit Risk Management section of this manual.

### 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 certain 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, where significant risk exposures are perceived, such as in the case of bankruptcy situations or loans collateralized by properties subject to environmental hazards. In addition, classification of 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.<sup>10</sup> Troubled commercial real estate loans, whose terms have been restructured, should be identified in the institution’s

10. 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.

internal credit review system and closely monitored by management.

## REAL ESTATE APPRAISALS AND EVALUATIONS

Bank regulators have a long-standing policy on real estate appraisals that emphasizes the importance of sound appraisal policies and procedures. In December 1987, the federal banking agencies jointly adopted supervisory guidelines for real estate appraisal policies and review procedures (which were revised in September 1992). With the passage of Title XI of the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA) of 1989, in August 1990, the federal banking agencies adopted regulations regarding the performance and utilization of appraisals by federally regulated financial institutions.

The intent of Title XI of FIRREA is to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. Title XI requires that real estate appraisals be performed in writing in accordance with uniform standards and by individuals with demonstrated competency and whose professional conduct is subject to effective supervision. In this regard, Title XI required each state to establish a program for certifying and licensing real estate appraisers, who are qualified to perform appraisals in connection with federally-related transactions (which are defined later in this section). Additionally, Title XI designated the Appraisal Foundation, a non-profit appraisal industry group, as the authority for establishing qualifications criteria for appraiser certification and standards for the performance of an appraisal. However, Title XI left to the states the authority to establish qualification standards for licensing. Title XI established the Appraisal Subcommittee of the Federal Financial Institutions Examination Council to monitor the requirements established to meet the intent of Title XI.

### Applicability of Title XI of FIRREA to Branches

The requirements of the appraisal regulations adopted by each of the federal banking agencies

pursuant to Title XI of FIRREA are discussed in the remainder of this section. The appraisal regulations are directly applicable only to FDIC-insured branches. In uninsured branches, examiners may use the regulations as general supervisory guidance when reviewing appraisal practices. As such, while an examiner in an uninsured branch may not cite the branch as being in violation of law or regulation for appraisal practices not consistent with the standards set forth in Title XI and the implementing appraisal regulations, the examiner may criticize such practices in the report of examination if considered appropriate from a risk management basis.

### Effective Date

Appraisals performed in connection with federally-related transactions after the effective date of August 9, 1990, are to comply with the regulations. Appraisals for real estate-related financial transactions entered into before August 9, 1990, do not have to comply with the regulations. However, the branch would have had to adhere to the Federal Reserve Board's supervisory guidelines, issued in 1987, for such real estate appraisals. Transactions are deemed to have been entered into and a loan is deemed to have been originated if there was a binding commitment to perform, before the effective date.

The requirement to use a state-certified or -licensed appraiser had a separate effective date of no later than December 31, 1992. However, states had the flexibility to adopt an earlier implementation date regarding state requirements that an appraiser be certified or licensed to perform an appraisal within their state. Financial institutions doing business in a state that had an effective date for mandatory use of certified or licensed appraiser earlier than the federally-mandated effective date would have had to abide by any state laws in this regard.

### Branch Appraisal and Evaluation Policy

Branch and head office management is responsible for adopting policies and procedures that establish effective real estate appraisal and

evaluation programs for the branch. Analyzing real estate collateral at a loan's inception and over its life requires a sufficient understanding of appraisals and evaluations to fully assess credit risk. While the appraisal plays an important role in the loan approval process, undue reliance should not be placed upon the collateral value in lieu of an adequate assessment of the borrower's repayment ability. However, when a credit becomes troubled, the primary source of repayment often shifts from the borrower's capacity to repay to the value of the collateral. For these reasons, it is important that branches have sound appraisal policies and procedures as a method of controlling risk.

### *Appraisal and Evaluation Programs*

The appraisal and evaluation programs of a branch should be tailored to the branch's size, location, and the nature of its real estate market and attendant real estate-related activity. Such programs should establish prudent standards and procedures that ensure written appraisals or evaluations are obtained and analyzed for real estate-related financial transactions before the branch makes its final credit decision.

The branch's appraisal and evaluation programs should also establish the manner in which it selects, evaluates, and monitors individuals who perform real estate appraisals or evaluations. The key elements of the branch's programs should ensure that individuals possess the requisite expertise to satisfactorily complete the assignment, hold the proper state certification or license, if applicable, and are capable of rendering a high quality, written appraisal or evaluation.

### *Compliance Procedures*

To ensure the branch's compliance with applicable supervisory guidelines, the branch should have established regulatory compliance procedures for all appraisals and evaluations. Additionally, a branch should critique selected appraisals and evaluations for adequacy and relevance of the data before making final credit decisions. The critique should consider the appropriateness of the methods and approaches used, and assess the reasonableness of the analyses, opinions, and conclusions. The branch

should maintain formal documentation or evidence of the critique to support the compliance review. An individual performing critiques, either an employee of the branch or an outside consultant, should have real estate-related training or experience and be independent of the transaction. The individual may not change the estimate of value of the appraisal or evaluation as a result of a critique.

### *Reappraisals and Reevaluations*

The program should also include a process for determining when a reappraisal and reevaluation is required on a prior transaction. In these situations, the original appraisal or evaluation will have become unreliable, e.g., the useful life of the appraisal or evaluation has ended and further circumstances dictate that the collateral should be reappraised or reevaluated. The individual who makes this determination should have real estate-related training or experience.

The decision to obtain a reappraisal or reevaluation will depend upon the condition and quality of a credit or investment and the soundness of the underlying collateral. The volatility of the local real estate market should also be considered in determining the need for a reappraisal or reevaluation. In certain situations, such as loan workouts, loan renewals, loan restructurings, or problem credits or investments, the need for a reappraisal or reevaluation should receive particularly close attention. In all cases, the information sources and analyses relied upon must sufficiently support a branch's determination of whether a reappraisal or reevaluation is required. Reappraisals should conform with appraisal regulations, and reevaluations should conform with applicable supervisory guidelines.

A reappraisal would not be required when an institution advances funds to protect its interest in a property, such as to repair damaged property, because these funds should be used to restore the damaged property to its original condition. If a loan workout involves modification of the terms and conditions of an existing credit, including acceptances of new or additional real estate collateral, which facilitates the orderly collection of the credit or reduces the institution's risk of loss, a reappraisal or reevaluation may be prudent, even if it is obtained after the modification occurs.

## FEDERALLY-RELATED FINANCIAL TRANSACTIONS

A federally-related transaction is defined in Title XI as a real estate-related financial transaction that a federal financial institution's regulatory agency engages in, contracts for, or regulates and that requires the services of an appraiser. Title XI further defines a real estate-related financial transaction as any transaction involving the sale, lease, purchase, investment, or exchange of real property, including interests in property or the financing thereof; the refinancing of real property or interests in real property; or the use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

The federal banking agencies recognize that not all real estate-related financial transactions require the services of a certified or licensed appraiser and, therefore, would not be considered federally-related transactions. While these transactions do not require a certified or licensed appraisal, an evaluation of the underlying collateral is required under existing supervisory guidelines.

### Transaction Value

The transaction value is defined as the amount of the loan or extension of credit under consideration. For a pool of loans or a mortgage-backed security, the transaction value is the amount of each individual loan. In determining transaction value, the senior and junior debt are considered separate transactions under the appraisal rule. However, a series of related transactions will be considered one transaction if it seems that an institution is attempting to avoid the appraisal requirement by structuring the transactions below the appraisal threshold.

### Transactions Not Requiring the Services of a Licensed or Certified Appraiser

Currently, the categories of transactions not requiring the services of an appraiser include transactions where:

- The transaction value is \$250,000 or less;
- A lien on real property has been taken as

collateral, solely through an abundance of caution and, as a consequence, the terms of the transaction have not been made more favorable than the terms would have been in the absence of a lien;

- The transaction is not secured by real estate;
- A lien on real estate has been taken for purposes other than the real estate's value;
- The transaction is a business loan that has a transaction value of \$1 million or less and is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;
- A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;
- The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met the Board's regulatory requirements for appraisals at the time of origination;
- The transaction is wholly or partially insured or guaranteed by a U.S. government agency or U.S. government-sponsored agency;
- The transaction either qualifies for sale to a U.S. government agency or U.S. government-sponsored agency, or involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate; or
- There is a subsequent transaction resulting from a maturing extension of credit, provided that:
  - The borrower has performed satisfactorily, according to the original terms;
  - No new monies have been advanced, other than as previously agreed;
  - The credit standing of the borrower has not deteriorated; and
  - There has been no obvious and material deterioration in market conditions or physical aspects of the property, which would threaten the branch's collateral protection; or
  - A branch purchases a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property

interest met the requirements of the appraisal regulation.

When a real estate-related financial transaction does not require a certified or licensed appraiser, the U.S. regulator may still require an appropriate evaluation of the real property that is consistent with the guidelines for real estate appraisal and evaluation programs.

## Obtaining an Appraisal

The branch or its agent is responsible for engaging the appraiser and must have sufficient time to analyze the appraisal as part of the decision process to enter into the transaction. A branch may not accept an appraisal prepared for a potential borrower as the appraisal for a federally related transaction. However, an appraisal prepared for one federally-regulated financial institution may be used by the branch, so long as the branch has established procedures for reviewing appraisals, the review indicates that the appraisal meets the regulation, and the review is documented in writing.

## When to Obtain an Appraisal

The branch should obtain the appraisal in sufficient time to be analyzed before the branch makes its final credit or other decision. In certain circumstances, when a branch acts to prudently protect its interest by modifying the terms and conditions of an existing extension of credit to facilitate orderly collection and thereby reduce its risk of loss, an appraisal or evaluation may be obtained after the branch makes its decision concerning the extension of credit.

The determination of when a federally-related transaction has occurred may be difficult to define in existing credits or in established lending arrangements. A new federally-related transaction is generally considered to have occurred when there is a potential change in the branch's exposure to risk. This includes, but is not limited to the following situations.

*Phased Developments*—The appraisal of an earlier phase cannot be used for a new phase. However, if the original appraisal was prepared for all phases of the project, the branch may use the project appraisal, provided that the appraisal

is still valid at the time the branch extends the additional credit for the new phase.

*Cross-Collateralization*—In cases where multiple loans are secured by separate parcels of real estate and are collateralized by the real estate pledged to other loans, the branch would not necessarily be required to reappraise all real estate collateral if an extension or renewal is granted on one of the loans. However, if the branch is relying on the excess collateral of the other loans to support the loan in question, the branch would have to have a valid appraisal on all real estate collateral.

*Loan Assumptions*—If a new borrower is substituted for the original borrower and the original borrower is released from any future obligation on the loan, the branch would be required to have a valid appraisal.

*Loan Restructuring and Workouts*—A branch would have to have a valid appraisal if the transaction is a refinancing.

*Foreclosures*—At the time title to foreclosed real estate passes to the branch, a branch needs to have a valid appraisal. It is recommended that the individual who performed the appraisal for the original credit decision should normally not perform the appraisal for this subsequent transaction.

*Sale of Other Real Estate Owned (OREO)*—A branch is required to have a valid appraisal when the sale occurs. The appraisal prepared for the foreclosure may be used, if that appraisal remains valid.

## Useful Life of Appraisals or Evaluations

The useful life of an appraisal or evaluation will vary depending upon the circumstances surrounding the property and the marketplace. When deciding if an appraisal or evaluation may be used for a subsequent transaction, a branch should determine if there has been any material change to the underlying assumptions, which would affect the original estimate of value.

Examples of factors that could cause material changes to reported values include the passage of time; the volatility of the local market; the

availability of financing; the inventory of competing properties; new improvements to, or lack of maintenance of, the subject or competing, surrounding properties; change in zoning; or environmental contamination. The branch should document its information sources and analyses used to determine that an existing appraisal or evaluation remains valid and that the branch will use that appraisal or evaluation in a subsequent transaction.

## Updated Appraisal

An updated appraisal is currently not acceptable as an appraisal under the Board of Governors' regulation. However, a branch may use an updated appraisal in the following cases:

- To evaluate real estate when a federally-related transaction has not occurred; or
- To assess the useful life of an appraisal.

## APPRAISAL REQUIREMENTS

The objective of an appraisal is to communicate the appraiser's reasoning and conclusions in a logical manner so that the reader is led to the appraiser's estimation of market value. The contents of appraisals should conform to the standards of the Board's appraisal regulation, if applicable, and the Uniform Standards of Professional Appraisal Practice (USPAP), promulgated by the Appraisal Standards Board of the Appraisal Foundation. The actual form, length, and content of appraisal reports may vary, depending on the type of property being appraised and the nature of the assignment. Standard forms completed in compliance with the rule and USPAP are also acceptable.

## Appraisal Options

A branch may engage an appraiser to perform either a Complete or Limited Appraisal. When performing a Complete Appraisal assignment, an appraisal must comply with all USPAP standards without departing from any binding requirements and specific guidelines when estimating market value. When performing a Limited Appraisal, the appraiser elects to invoke the

Departure Provision which allows the appraiser to depart, under limited conditions, from standards identified as specific guidelines. For example, in a Limited Appraisal, the appraiser might not utilize all three approaches to value. Departure from standards designed as binding requirements is not permitted.

A branch and appraiser must concur that use of the Departure Provision is appropriate for the transaction before the appraiser commences the appraisal assignment. The appraiser must ensure that the resulting appraisal report will not mislead the branch or agency or other intended users of the appraisal report. The banking regulators do not prohibit the use of a Limited Appraisal for a federally related transaction, but the bank regulators believe that branches should be cautious in their use of a Limited Appraisal because it will be less thorough than a Complete Appraisal.

Complete and Limited Appraisal assignments may be reported in three different report formats: a Self-Contained Report, a Summary Report, or a Restricted Report. The major difference among these three reports relates to the degree of detail presented in the report by the appraiser. The Self-Contained Appraisal Report provides the most detail, while the Summary Appraisal Report presents the information in a condensed manner. The Restricted Report provides a capsulized report with the supporting details maintained in the appraiser's files.

The banking agencies believe that the Restricted Report format will not be appropriate to underwrite a significant number of federally related transactions due to the lack of sufficient supporting information and analysis in the appraisal report. However, it might be appropriate to use this type of appraisal report for ongoing collateral monitoring of a branch's real estate transactions and under other circumstances when a branch's program requires an evaluation.

Moreover, since a branch is responsible for selecting the appropriate appraisal report to support its underwriting decisions, its program should identify the type of appraisal report that will be appropriate for various lending transactions. The branch's program should consider the risk, size, and complexity of the individual loan and the supporting collateral when determining the level of appraisal development and the type of report format that will be ordered. When ordering an appraisal report, institutions may want to consider the benefits of a written

engagement letter that outlines the branch's expectations and delineated each party's responsibilities, especially for large, complex, or out-of-area properties.

## Appraisal Standards

Title XI mandated that the minimum standards for Complete appraisals performed in connection with federally-related transactions are standards set forth in USPAP together with any other standards that the federal banking agencies deem necessary. In summary, an appraisal must:

- Be performed by a qualified, independent staff or fee-paid appraiser, selected by the branch, who is competent and knowledgeable of relevant markets. The appraiser must also hold the proper state certification or license as required under the appraisal regulations. An independent appraisal is one in which the appraiser is not participating in the administration of the credit or in the approval of the transaction and has no interest, financial or otherwise, in the property;
- Result in a market value that is defined as the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably and the price is not affected by any undue stimulus;
- State the market value in terms of the cash equivalent value, which reflects the value of the property without the influence of special or creative financing or seller concessions;
- Follow a reasonable valuation method, which addresses cost, income, and direct sales comparison approaches to determine market value, unless the appraiser fully explains and documents the elimination of an approach;
- Support the current valuation of the real estate. All assumptions and projections should be supportable by current market conditions and expectations of current market trends. In the case of income property, the capitalization rate, discount rate, net income and/or loss projections, cash flow, financing terms, and absorption rate should be reasonable and supportable by current market conditions;
- Document and explain how the discount and capitalization rates used in generating present value estimates were derived;
- Render the "as is" value, which reflects the value of the property in its current physical condition and subject to the zoning in effect as of the appraisal date. Appropriate deductions and discounts should be made for proposed development projects to reflect holding costs, marketing expenses, and entrepreneurial profit, which are based on stabilized occupancy for commercial projects or a retail sales program for residential projects;
- Report the sales history on the appraised property for one year for 1-to-4 family residential properties and three years for all other types of properties;
- Address a proposed project's marketability and feasibility prospects. Studies prepared by a party other than the appraiser must be verified to the extent assumptions are utilized. The appraiser's acceptance or rejection of the third party study and its impact on value must be fully explained;
- State the marketing period for the appraised property, the effective date of the appraisal, and the date the appraisal was rendered;
- Include a legal description of the subject property;
- Identify and separately value any personal property, fixtures, and intangible items that are not real property but are included in the appraisal, and discuss the impact of their inclusion or exclusion on the estimate of market value of the real property;
- Contain an appraiser's certification statement in which the appraiser attests to the accuracy of the data, the disclosure of assumptions, and independence from the transaction; states whether an inspection of the property was made; discloses any professional assistance received from another appraiser; and certifies that a fee, contingent on the value rendered, was not received; and
- The appraisal regulations and USPAP provide a complete listing of the appraisal standards.

## Appraisal Valuation Approaches

There are three basic approaches used in appraising the market value of real estate in a Complete Appraisal:

- Cost Approach;
- Market Data or Direct Comparable Sales Approach; and
- Capitalization of Income Approach.

All three approaches have particular merits depending upon the type of real estate being appraised. For single family residential property, the cost and comparable sales approaches are most frequently used because the common use of the property is the personal residence of the owner. However, if a single family residential property is intended to be used as a rental property, the appraiser would have to consider the income approach and the cost and comparable sales approaches. For special use commercial properties, the appraiser may have difficulty in obtaining sales data on comparable properties and may have to base the value estimate on the cost and capitalization of income approach. 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.

## Value Correlation

The three value estimates—cost, market, 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 judgment must be exercised in analyzing the results and determining the estimate of market value.

## Cost Approach

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 depreciation, i.e., 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.

## Market Data or Direct Sales Comparison Approach

The essence of this approach is to determine the price at which similar properties have sold for recently 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 market approach to value estimation is essential in nearly every appraisal of real property and is based on the following assumptions:

- Market value is the highest price for which a property is deemed most likely to sell in a competitive market;
- A reasonable time is allowed for exposure of the property in the open market;
- Payment is to be made in cash or on terms reasonably equivalent to cash or on typical financing terms available at the time of the appraisal;
- Both the buyer and seller are typically motivated and the price is not affected by undue stimulus; and
- Both buyer and seller act prudently and knowledgeably and have reasonable knowledge of the various uses to which the property may be put.

The application of this approach produces an estimate of value of a property by comparing it with similar properties that have been sold recently. The process used in determining the degree of comparability of two or more properties involves judgment as to their similarity with respect to age, location, condition, construction, layout, and equipment. The sales price or list price of those properties deemed most comparable tend to set the range in which the value of the subject property lies.

## Capitalization of Income Approach

The income approach estimates the project's expected income over time converted to an estimate of its present value. The income approach typically is used to determine the market value of income producing properties, such as office buildings, apartment complexes, hotels, and shopping centers. In the income approach, the appraiser can use several different capitalization or discounted cash flow techniques to arrive at a market value. These techniques include band-of-investments method, mortgage equity method, annuity method, and land residual technique. The use of a particular technique will depend upon 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 this 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 method. 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 information provides gross rental data and 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 being paid from revenues derived from the subject property and by comparable properties. Historical trends in these expense items are also determined;
- Time frame for achieving a "stabilized" or normal occupancy and rent levels (also referred to as holding period); and
- An appropriate capitalization rate and valuation technique are selected and applied to net income to establish a value estimate.

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 "cap" rate. Stabilized income generally is 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 in terms of current income.

The use of this technique assumes that either the stabilized income or the "cap" rate used 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 will 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. For further discussion, refer to the section of this manual on Real Estate Loans.

## Other Definitions of Value

An appraisal for a federally-related transaction must reflect a market value as defined in the

regulations. The regulations also require that, for development projects, the appraisal contain the “as is” value as of the date of the appraisal. However, there are other definitions of value that are encountered in appraising and evaluating real estate transactions. These include:

**Fair Value.** This term is an accounting term that is generally defined as the amount, in cash or cash equivalent value or other consideration, that a real estate parcel would yield in a current sale between a willing buyer and a willing seller (i.e., selling price), that is, other than in a forced or liquidation sale. According to accounting literature, fair value is generally used in valuing assets in troubled debt restructuring, quasi-reorganizations, nonmonetary transactions, 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 term 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 than participants 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 term assumes that there is little or no current demand for the property and that the property needs to be disposed of quickly, resulting in the owner sacrificing potential property appreciation for an immediate sale.

**Going-Concern Value.** This term 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.

**Assessed Value.** This term 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 term is recognized under generally accepted accounting prin-

ciples (GAAP) 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.

The appraiser should state the definition of value reported in the appraisal, and, for federally-related transactions, the value must meet the market value definition as defined in the regulations. This value is the most probable price that a property should bring in a competitive and open market under all conditions requisite to a fair sale, assuming the buyer and seller are both acting prudently and knowledgeably and the price is not affected by undue stimulus. Other presentations of value, in addition to market value, are allowed and may be included in the appraisal at the request of the branch.

## EVALUATION REQUIREMENTS

The appraisal regulations identify certain real estate-related financial transactions that do not require the services of an appraiser (i.e., do not need an appraisal). In the context of Title XI of FIRREA, an appraisal means the kind of specialized opinion as to the value of real estate containing certain formal elements recognized by appraisal industry practices and standards. For transactions that do not require an appraisal by a licensed or certified appraiser under the appraisal regulations, the branch should establish an evaluation program and perform an appropriate evaluation of the real estate for these transactions as a prudent banking practice. The evaluation should result in a determination of value that will assist the branch in assessing the soundness of the transaction and that will protect the branch’s interest in the transaction. Further, the evaluation need not meet all of the detailed requirements of an appraisal as set forth in the appraisal regulations.

Bank regulators’ appraisal regulations allow an institution to use an appropriate evaluation of

real estate rather than an appraisal when the transaction:

- Has a value of \$250,000 or less;
- Is a business loan of \$1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; or
- Involves an existing extension of credit at the lending branch, provided that: (i) there has been no obvious and material change in the market conditions or physical aspects of the property that threaten the adequacy of the branch's real estate collateral protection after the transaction, even with the advancement of new monies; or (ii) there is no advancement of new monies other than funds necessary to cover reasonable closing costs.

The branch is not precluded from obtaining an appraisal that conforms to the regulation for any real estate-related financial transaction. If a branch makes loans that may be sold into the secondary market at a later date, the branch may need to ensure that they meet the secondary mortgage market requirements.

## Form and Content of Evaluations

The documentation for evaluations should fully support the estimate of value and include sufficient information to understand the evaluator's analysis and assumptions. There is no requirement that the evaluator use a particular form or valuation approach but the analysis should be applicable to the type of property and fully explain the value rendered.

An evaluation, at a minimum, should:

- Be written;
- Include the preparer's name, address, and signature, and the effective date of the evaluation;
- Describe the real estate collateral, its condition, its current and projected use;
- Describe the source(s) of information used in the analysis;
- Describe the analysis and supporting information; and
- Provide an estimate of the real estate's market value, with any limiting conditions.

An individual who conducts an evaluation should have real estate-related training or expe-

rience relevant to the type of property but does not have to be a state-licensed or -certified appraiser. Prudent practices generally require that, as the branch's exposure in a real estate-related financial transaction increases, a more detailed evaluation should be performed, whether or not specifically subject to appraisal regulations.

An evaluation for a transaction that needs a more detailed analysis should fully describe the property and discuss its use, especially for nonresidential property. An evaluation report should include calculations, supporting assumptions, and, if utilized, a discussion of comparable sales. Documentation should be sufficient to allow an institution to understand the analysis, assumptions, and conclusions. An institution's own real estate loan portfolio experience and value estimates prepared for recent loans on comparable properties might provide a basis for evaluations.

An evaluation for a transaction that requires a less detailed analysis may be based upon information, such as comparable property sales information from sales data services, for example, the multiple listing service or current tax assessed value in appropriate situations. Further, the branch's own real estate loan portfolio experience and value estimates, which were prepared for recent loans on comparable properties where appraisals meeting the requirements of the regulation were obtained, may be used. Regardless of the method, the branch must document its analysis and findings in the loan file.

## Letter Updates

A branch may use letter updates to an appraisal as an evaluation even though such updates do not conform to the appraisal regulations and would not be acceptable for the initial credit decision for federally-related transactions. For example, an existing appraisal for a first mortgage might be updated for a subsequent home equity line of credit where the extension of credit is below the threshold amount.

## QUALIFICATIONS CRITERIA FOR APPRAISERS AND EVALUATORS

The accuracy of an appraisal or evaluation depends on the competence and integrity of the

individual performing the appraisal or evaluation and the expertise of the appraiser or evaluator at developing and interpreting pertinent data for the subject property. Appraisers and evaluators should have adequate training, experience, and knowledge of the local real estate market to make sound judgments concerning the value of a particular property. The level of training, experience, and knowledge should be commensurate with the type and complexity of the property to be valued. Additionally, appraisers and evaluators should be independent of the credit decision, have no interest in the property being appraised, and have no affiliations or associations with the potential borrower.

## Appraiser Qualifications

Under Title XI of FIRREA, two classifications of appraisers were identified to be used in federally-related transactions: “state-certified appraiser” and “state-licensed appraiser.” For a certified appraiser, Title XI contemplated that the states would adopt similar standards for certification based on the qualification criteria of the Appraiser Qualifications Board of the Appraisal Foundation. These standards set forth minimum educational, testing, experience, and continuing education requirements. For a licensed appraiser, the states have some latitude in establishing qualification standards provided that the criteria are adequate to protect federal financial and public policy interests.

The Appraisal Subcommittee of the FFIEC is responsible for monitoring the states for compliance with Title XI. The federal banking agencies also have the authority to impose additional certification and licensing requirements to those adopted by a given state.

## Selection of an Appraiser

In selecting an appraiser for an appraisal assignment, a branch is expected to consider whether the individual holds the proper state certification or license and has the appropriate experience and educational background to complete the assignment. Financial institutions may not exclude a qualified appraiser from consideration for an appraisal assignment solely because the appraiser lacks membership in a particular appraisal organization or does not hold a par-

ticular designation from an appraisal association, organization, or society.

In that regard, branches should treat all appraisers fairly and equitably in determining whether to use the services of a particular appraiser. Generally, financial institutions have established procedures for selecting appraisers and maintaining an approved appraiser list. The practice of pre-approving appraisers for on-going appraisal work and maintaining an approved appraiser list is acceptable as long as all appraisers are required to follow the same approval process. However, a branch that requires appraisers who are not members of a particular appraisal organization to formally apply, pay an application fee, and submit samples of previous appraisal reports for review—but does not have identical requirements for appraisers who are members of certain appraisal organizations—would be viewed as having a questionable selection process.

## APPRAISALS PERFORMED BY CERTIFIED OR LICENSED APPRAISERS

In summary, a federally-insured branch is required to use a Certified Appraiser for:

- All federally-related transactions over \$1 million;
- Nonresidential federally-related transactions of \$250,000 or more; and
- Complex residential federally-related transactions of \$250,000 or more.

A federally-insured branch is required to use a Licensed Appraiser for:

- All other federally-related transactions over the \$250,000 transaction value not requiring the services of a certified appraiser. These also may be performed by a certified appraiser.

Some of the states have adopted other appraiser designations, which may cause confusion on whether a particular appraiser holds the appropriate designation for a given appraisal assignment. Additionally, some states have used designations such as “certified residential” appraiser and “certified general” appraiser, which leads to further confusion. Other states have no specified license designation but have

used the term “certified residential” based on the standards for licensing. For this reason, the branch needs to understand (1) the qualifications criteria set forth by the state appraiser regulatory body and (2) whether these standards are equivalent to the federal designations as accepted by the Appraisal Subcommittee.

## Other Appraiser Designations

The Appraisal Subcommittee recognized two other appraiser designations: certified residential appraiser and transitional license. For the certified residential appraiser, the minimum qualification standards are those established by the Appraiser Qualifications Board for “certified residential real estate appraiser.” Under the appraisal regulations, a certified residential appraiser would be permitted to appraise real estate in connection with a federally-related transaction designated for a “certified” appraiser as long as the individual is competent for the particular appraisal assignment.

The Appraisal Subcommittee and the federal banking agencies also recognized a transitional license, which allowed a state to issue a license to an appraiser provided that the individual had passed an examination and had satisfied either the education or experience requirement. A transitional licensed appraiser was permitted to appraise real estate collateral in connection with a federally-related transaction as if licensed. The transitionally-licensed appraiser was expected to complete the missing requirement within a set time frame or the license would expire. The recognition of a transitional license was believed to be necessary to ease the initial problems and inefficiencies resulting from the establishment of a new regulatory program. The Appraisal Subcommittee advised the states that the use of the transitional license should be phased out over time once the appraiser regulatory program is fully established. As a result, the use of the transitional license and the applicable time frame varies from state to state.

## Qualifications of Individuals Who Can Perform Evaluations

Evaluations can be performed by a competent person who has experience in real estate-related

activities, including but not limited to appraisals, real estate lending experience, real estate consulting, and real estate sales. An individual performing an evaluation need not be licensed or certified. The branch’s evaluation procedures should have established standards for selecting qualified individuals to perform evaluations and confirming their qualifications and independence to perform an evaluation for a particular transaction.

## Supervisory Policy and Evaluations

A branch’s appraisal and evaluation policies and procedures should be reviewed as part of the examination of its overall real estate-related activities to ensure compliance with regulations, if a federally-insured branch, and to evaluate risk management techniques as appropriate. This process would include a review of the procedures for selecting an appraiser for a particular appraisal assignment and confirming that the appraiser is qualified, independent, and licensed/certified to undertake the assignment. If a branch maintains a list of qualified real estate appraisers acceptable for the branch’s use, the examiner should ascertain whether senior management of the branch has periodically reviewed and approved the list.

When analyzing individual credits, examiners should analyze appraisals or evaluations to determine that the methods, assumptions, findings, and conclusions are reasonable and in compliance with any applicable appraisal regulations and supervisory guidelines. Examiners should not challenge the underlying assumptions, including discount rates and capitalization rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. Additionally, an examiner is not bound to accept the results of the appraisal or evaluation, regardless of whether a new appraisal or evaluation was requested during the examination. If an examiner concludes that an appraisal or evaluation is deficient for any reason, that fact will be taken into account in reaching a judgment on the quality of the credit.

When the examiner can establish that the underlying facts or assumptions are inappropriate and can support alternative assumptions, the examiner may adjust the estimated value of the property for credit analysis purposes. It is

important to emphasize that an examiner's overall analysis and classification of a credit may be based upon other credit or underwriting standards, even if the loan is secured by real property whose value is supported by an appraisal or evaluation. Further discussion on the examiner's assessment of value for loan classification can be found in sections in this manual on Classification of Credits.

Significant failures to meet applicable standards and procedures as outlined previously should be criticized and corrective action should be required. Furthermore, inadequate appraisal and evaluation procedures may be considered an unsafe and unsound banking practice if the failure to accurately reflect the value of assets on a timely basis misrepresents the branch's financial condition. In this situation, formal corrective measures will be pursued as appropriate.

The appraisal regulation and guidelines require that federally-insured financial institutions use the services of qualified, independent, certified or licensed appraisers to perform appraisals. A branch that knowingly uses the services of an individual to perform an appraisal in connection with a federally-related transaction who is not properly certified or licensed is in violation of Section 1120(a)(1) of Title XI of FIRREA. Any action of a state-certified or -licensed appraiser that is contrary to the purpose of Title XI should be reported to the branch's appropriate federal and/or state regulators for referral to the state appraiser regulatory agency for investigation.

## ENVIRONMENTAL LIABILITY

In connection with any real estate lending activity, a branch and its legal entity, the foreign banking organization, may be subject to liability associated with the clean-up of hazardous substance contamination pursuant to the Comprehensive Environmental Response, Compensation and Liability Act (CERCLA), the federal superfund statute. CERCLA was enacted in response to the growing problem of improper handling and disposal of hazardous substances. CERCLA authorizes the Environmental Protection Agency (EPA) to clean up hazardous waste sites and to recover costs associated with the clean up from entities specified in the statute. The superfund statute is the primary federal law dealing with hazardous substance contamination. However, there are numerous other federal

and state statutes that establish environmental liability that could place banking organizations at risk. For example, underground storage tanks are also covered by separate federal legislation.<sup>11</sup>

While the superfund statute was enacted in 1980, it has been only since the mid-1980s that court actions have resulted in some banking organizations being held liable for the clean-up of hazardous substance contamination. These early court decisions had a wide array of interpretations as to whether banking organizations are owners or operators of contaminated facilities and thereby liable under the superfund statute for clean-up costs. These decisions led to uncertainty on the part of banking organizations as to how best to protect themselves from environmental liability.

The relevant provisions of CERCLA, the so-called "superfund" statute as it pertains to banking organizations indicate which persons or entities are subject to liability for clean-up costs of hazardous substance contamination. These include "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."<sup>12</sup> A person or entity that transports or arranges to transport hazardous substances can also be held liable for cleaning up contamination under the superfund statute.

The liability imposed by the superfund statute is strict liability, which means the government does not have to prove that the owners or operators had knowledge of or caused the hazardous substance contamination. Moreover, liability is joint and several, which allows the government to seek recovery of the entire cost of the clean up from any individual party that is liable for those clean-up costs under CERCLA. In this connection, CERCLA does not limit the bringing of such actions to the EPA but permits such actions to be brought by third parties.

CERCLA provides a secured creditor exemption 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

11. Resource Conservation and Recovery Act of 1987 (RCRA).

12. CERCLA, Section 107(a).

interest in the vessel or facility.”<sup>13</sup> However, this exception has not provided banking organizations with an effective “safe harbor” because early court decisions worked to limit the application of this exemption. Specifically, courts held that actions by lenders to protect their security interests may result in the banking organization “participating in the management” of a vessel or facility, thereby voiding the exemption. Additionally, once the title to a foreclosed property passes to the banking organization, courts held that the exemption no longer applies and that the banking organization is liable under the superfund statute as an “owner” of the property. Under some circumstances, CERCLA may exempt landowners who acquire property without the knowledge of pre-existing conditions (the so-called “innocent landowner defense”). However, the courts applied a stringent standard to qualify for this defense. Because little guidance is provided by the statute as to what constitutes the appropriate timing and degree of “due diligence” to successfully employ this defense, banking organizations should exercise caution before relying on it.

## Overview of Environmental Hazards

Environmental risk can be characterized as adverse consequences resulting from having generated or handled hazardous substances or otherwise having been associated with the aftermath of subsequent contamination. The following discussion highlights some common environmental hazards but by no means covers all environmental hazards.

Hazardous substance contamination is most often associated with industrial or manufacturing processes that involve chemicals or solvents in the manufacturing process or as waste products. For years, these types of hazardous substances were disposed of in land fills or just dumped on industrial sites. Hazardous substances are also found in many other lines of business. The following examples demonstrate the diverse sources of potential hazardous substance contamination, which should be of concern to banking organizations.

- Farmers and ranchers (use of 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 (local and long haul transporters of hazardous substances, such as fuel or chemicals).
- The real estate industry has taken the brunt of the adverse affects of hazardous waste contamination. In addition to having land contaminated with toxic substances, construction methods for major construction projects, such as commercial buildings, have utilized materials that have been subsequently determined to be hazardous resulting in significant declines in their value. For example, asbestos was commonly used in commercial construction from the 1950s to the late 1970s. Asbestos was found to be a health hazard and now must meet certain federal and, in many instances, state requirements for costly removal or abatement (enclosing or otherwise sealing off).
- Another common source of hazardous substance contamination is underground storage tanks. Leaks in these tanks not only contaminate the surrounding ground but often flow into ground water and travel far away from the original contamination site. As contamination spreads to other sites, clean-up costs escalate.

## Impact on Banking Organization

Banking organizations may encounter losses arising from environmental liability in several ways. The greatest risk to banks resulting from the superfund statute and other environmental liability statutes is the possibility of being held solely liable for costly environmental clean ups, such as hazardous substance contamination. If a bank is found to be a responsible party under CERCLA, it may find itself responsible for cleaning up a contaminated site at a cost that far exceeds any outstanding loan balance. This risk of loss results from an interpretation of the superfund statute as providing for joint and several liability. Any responsible party, including a branch and the foreign banking organization or FBO, as the branch’s legal entity, could be forced to pay the full cost of any clean up. Of course, the branch or FBO may attempt to

13. CERCLA, Section 101(20)(A).

recover such costs from the borrower, or from the owner, if different than the borrower, provided that the borrower or owner continues in existence and is solvent. Banking organizations may be held liable for the clean up of hazardous substance contaminations in situations where it:

- Takes title to property pursuant to foreclosure;
- Involves the banking organization's personnel or contractors engaged by the bank in day-to-day management of the facility;
- Takes actions designed to make the contaminated property salable, possibly resulting in further contamination;
- Acts in a fiduciary capacity, including management involvement in the day-to-day operations of industrial or commercial concerns and purchasing or selling contaminated property;
- Owns or acquires (by merger or acquisition), subsidiaries involved in activities that might result in a finding of environmental liability; or
- Owns or acquires, for future expansion, premises that have been previously contaminated by hazardous substances. For example, site contamination at a branch office where a service station with underground storage tanks once operated. Premises or other real estate owned could also be contaminated by asbestos requiring costly clean up or abatement.

A more common situation encountered by banking organizations has been where real property collateral is found to be contaminated by hazardous substances. The value of contaminated real property collateral can decline dramatically depending on the degree of contamination. As the projected clean-up costs increase, the borrower may not be able to provide the necessary funds to remove contaminated materials. In making its determination whether to foreclose, the lender must estimate the potential clean-up costs. In many cases, this estimated cost has been found to be well in excess of the outstanding loan balance and the lender has elected to abandon its security interest in the property and write-off the loan. This situation occurs, regardless of the fact that the superfund statute provides a secured creditor exemption. Some courts have not extended this exemption to situations where lenders have taken title to a property pursuant to foreclosure. These rulings have been based on a strict reading of the statute that provides the exemption to "security interests" only.

Risk of credit losses can also arise where the credit quality of individual borrowers (operators, generators, or transporters of hazardous substances) deteriorates markedly as a result of being required to clean up hazardous substance contamination. Banking organizations must be aware that significant clean-up costs borne by the borrower could threaten the borrower's solvency and jeopardize the lender's ultimate collection of outstanding loans to that borrower regardless of the fact that no real property collateral is involved. Therefore, ultimate collection of loans to fund operations or to acquire manufacturing or transportation equipment can be jeopardized by the borrower's generating or handling of hazardous substances in an improper manner. Further, some bankruptcy courts have required clean up of hazardous substance contamination before distribution of a debtor's estate to secured creditors.

Borrowers may have existing subsidiaries or may be involved in merger and acquisition activity that may place the borrower at risk for the activities of others that 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 clean-up costs. Additionally, borrowers can be held liable for contamination that occurred before they owned or used real estate.

## Protection Against Environmental Liability

Lenders have numerous ways to identify and minimize their exposure to environmental liability. Because environmental liability is relatively recent, procedures used to safeguard against such liability are evolving. Generally, however, banking organizations should have in place adequate safeguards and controls to limit their exposure to potential environmental liability. Loan policies and procedures should address methods for identifying potential environmental problems relating to credit requests and existing loans. 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 held

to a more stringent due diligence investigation than borrowers in low-risk industries or localities.

In addition to establishing procedures for granting credit, procedures should be developed and applied to portfolio analysis, credit monitoring, loan workout situations, and—before taking title to real property—foreclosures. Banks may avoid or mitigate potential environmental liability by having sound policies and procedures designed to identify, assess, and control environmental liability.

At the same time, banking organizations must be careful that any lending policies and procedures, especially those undertaken to assess and control environmental liability, cannot be construed as taking an active role in participating in the management or day-to-day operations of the borrower's business. Activities that could be considered active participation in the management of the borrower's business and therefore subject the banking organization to potential liability, include but are not limited to:

- Having branch or FBO employees serve as members of the borrower's board of directors or actively participating in board decisions;
- Assisting in day-to-day management and operating decisions; or
- Actively determining management changes.

These considerations are especially important when the banking organization is actively involved in loan workouts or debt restructuring.

The first step in identifying and minimizing environmental risk is for banks to perform environmental reviews. Such reviews may be performed by loan officers or others and typically identify past practices and uses of the facility and property, evaluate regulatory compliance, if applicable, and identify potential future problems. This review is accomplished by interviewing persons familiar with past and present uses of the facility and property, reviewing relevant records and documents, and visiting and inspecting the site.

Where 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 review and inspection of the facility and property. Environmental audits differ markedly from environmental assessments in that independent environmental engineers are employed to

investigate, in greater detail, those factors listed previously and actually test for hazardous substance contamination. Such testing might require collecting and analyzing air samples, surface soil samples, and subsurface soil samples and drilling wells to sample ground water.

Other measures used by some banking organizations to assist in identifying and minimizing environmental liability include obtaining indemnities from borrowers for any clean-up costs incurred by the bank and including affirmative covenants in loan agreements (and attendant default provisions) requiring the borrower to comply with all applicable environmental regulations. Although these measures may provide some aid in identifying and minimizing potential environmental liability, they are not a substitute for environmental reviews, assessments, and audits because their effectiveness is dependent upon the financial strength of the borrower.

The foregoing discussion provides general guidance on environmental liability. Because of continuing legal and regulatory changes and court decisions in this area, all policies, practices, and procedures should be periodically reviewed by legal counsel to ensure that they are adequate and up-to-date.

## Conclusion

Potential environmental liability can touch on a great number of loans to borrowers in many industries or localities. Moreover, nonlending activities and affiliations can lead to environmental liability depending upon the nature of these activities and the degree of participation that the banking organization, whether domestic or foreign, exercises in its U.S. operations. Such liability can result in losses arising from hazardous substance contamination because banking organizations are held directly liable for costly court ordered clean ups. Additionally, the banking organization's ability to collect the loans it makes may be hampered by significant declines in collateral value or the inability of a borrower to meet debt payments, after paying for costly clean-ups of hazardous substance contamination.

Banking organizations must understand the nature of environmental liability arising from hazardous substance contamination. Additionally, they should take prudential steps to identify and minimize their potential environmental

liability. Indeed, the common thread to environmental liability is the existence of hazardous substances, not types of borrowers, lines of business, or real property.

# Real Estate Loans

## Examination Objectives

Effective date July 1997

## Section 3100.2

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1. To determine if policies, practices, procedures, and internal controls regarding real estate lending activities and appraisals are adequate.
2. To determine if branch officers are operating in conformance with established guidelines.
3. To evaluate the portfolio for collateral sufficiency, performance, credit quality, and collectibility.
4. To determine that appraisals performed in connection with federally-related transactions comply with the minimum standards of the appraisal regulations and the Uniform Standards of Professional Appraisal Practice.
5. To determine whether adequate safeguards and controls have been established to limit exposure to potential environmental liability.
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 or regulations have been noted.

# Real Estate Loans

## Examination Procedures

Effective date July 1997

## Section 3100.3

Refer to the Credit Risk Management examination procedures for general procedures to assess the risk of real estate lending activities. However, if the branch engages in significant real estate lending activities, and additional information is needed, the examiner should perform the following examination procedures.

1. If selected for implementation, complete or update the Internal Control Questionnaire.
2. Determine if deficiencies noted at previous examinations and internal/external audits have been adequately addressed by management.
3. Review the following information for selected real estate loans:
  - 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 to outstanding debt and determine whether the loan's LTV ratio is in excess of the suggested supervisory LTV limits.
  - d. Assess the adequacy of the appraisal or evaluation.
  - e. Determine if the loan complies with branch policy.
  - f. Identify deficiencies in the loan's credit files or the collateral records.
  - g. Review the borrower's compliance with loan covenants, and payment performance.
  - h. Determine if any problems exist that may jeopardize the repayment of the loan.
  - i. If the loan was classified during the preceding examination and has subsequently been paid off, determine the source of funds for repayment (e.g. another loan, a sale to another institution, or repossession of the property.)
  - j. If the loan is to a firm or to individuals who provided professional services to the branch, such as attorneys, accountants, or appraisers, determine if the borrower received preferential treatment.
4. Evaluate the branch's real estate lending activities, taking into account the following items:

- a. The adequacy of the policies, procedures, and internal controls.
- b. The adherence to policies and procedures, and accuracy and completeness of the branch's records.
- c. The competency of management and loan officers.
- d. The adequacy of systems to monitor both favorable and adverse trends in the overall real estate industry.
- e. The quality of the real estate loan portfolio, including the level and trends of classified and criticized loans, and delinquent and nonaccruing loans. Ascertain if management is aware of the causes of existing problems.
- f. Loans lacking current and complete financial information or documentation. Address deficiencies related to items such as appraisals, feasibility studies, the environmental impact study, takeout commitment, title policy, deeds of trust, and mortgage notes.
- g. Compliance with laws, regulations, and applicable regulatory policy.
- h. Independent verification of collateral values.

### APPRAISALS

5. Review the branch's appraisal and evaluation program, making sure it includes guidelines for obtaining appraisals from third party appraisers and evaluating appraisals in-house.
6. Evaluate the adequacy and integrity of the appraisal and evaluation process, considering:
  - a. The appropriateness of the methods, assumptions, and techniques used, and compliance with interagency real estate appraisal and evaluation guidelines.
  - b. Other appraisal deficiencies such as:
    - Misrepresentation of data,
    - Inadequate analysis,
    - Use of dissimilar comparables,
    - Underestimation of factors, such as construction cost, construction period, lease-up period, and rent concessions,

- Use of best case assumptions for the income approach, or
  - Overly optimistic assumptions, such as a high absorption rate in an overbuilt market.
9. Review loan agreements to determine if warranties, representations, and indemnifications have been included in loan agreements designed to protect the branch from losses stemming from hazardous substance contamination. (Although such provisions provide some protection for the lender, these agreements are not binding against the government or third parties. Such contractual protections are only as secure as the borrower's financial strength.)

## ENVIRONMENTAL LIABILITY

7. Determine if policies, procedures, and other safeguards and controls have been established to avoid or mitigate potential environmental liability.
8. Determine whether appropriate periodic analysis of potential environmental liability is conducted.
10. Update workpapers with any information that will facilitate future examinations.

# Real Estate Loans

## Internal Control Questionnaire

Effective date July 1997

## Section 3100.4

Refer to the Credit Risk Management Internal Control Questionnaire, section 3010.4, for a general review of the branch's internal controls, policies, practices, and procedures. If the branch engages in significant real estate lending activities, and additional information is needed, the examiner should complete the following ICQ. For audit procedures, refer to the Credit Risk Management section 3010.5.

1. Has branch and head office management adopted written real estate lending policies that define:
  - a. Target market?
  - b. Acceptable collateral?
  - c. Prudent, clear, and measurable underwriting standards for each type of property such as:
    - Maximum loan amount and maturity?
    - Repayment terms?
    - Pricing structure?
    - Loan-to-value (LTV) limits?
  - d. Approval procedures and authority limits?
  - e. Loan administration procedures that include documentation, disbursement, collateral inspection, collection, and loan review?
  - f. Minimum loan documentation standards, such as minimum frequency and type of financial information required for each category of real estate loan?
  - g. Appraisals and evaluations?
  - h. Reporting requirements to the head office relative to loan portfolio monitoring, including items such as compliance with lending policies and procedures, delinquency trends, and problem loans?
2. Are policies and procedures appropriate to the size and sophistication of the branch, and are they reviewed annually to ensure they are compatible with changing market conditions?
3. Has someone been assigned the responsibility for maintaining the document files?
4. Are notes and other original documents properly safeguarded?
5. Is a tickler system or a check sheet used to ensure that required documents are received and on file?
6. Are loan files reviewed after closing to determine if all documents are properly

drawn, executed, recorded, and filed within the loan files?

7. Is there a procedure for monitoring escrow accounts to determine that private mortgage insurance premiums and hazard insurance premiums are current?
8. Do hazard insurance policies include a loss payable clause to the branch?
9. Are escrow accounts reviewed at least annually to determine if monthly deposits will cover anticipated disbursements?
10. Are disbursements for taxes and insurance supported by records showing the nature and purpose of the disbursement?
11. Does the branch have adequate collection procedures to monitor delinquencies and pursue foreclosure?
12. Are "in-substance foreclosure" properties appropriately identified?
13. Are properties to which the branch has obtained title appropriately transferred to other real estate owned (OREO)? Refer to the Other Real Estate Owned section in this manual for requirements.

## APPRAISALS AND EVALUATIONS

14. Do appraisal policies include:
  - a. Guidelines for selecting, evaluating, and monitoring the individuals performing appraisals or evaluations, whether third party or in-house?
  - b. Procedures for when to obtain appraisals and evaluations on new loans, as well as reappraisals or reevaluations on existing loans?
  - c. Review procedures to determine that appraisals and evaluations comply with supervisory guidelines?
15. If appropriate, does the appraisal meet the minimum standards of the appraisal regulations and the Uniform Standards of Professional Appraisal Practice, including:
  - a. Purpose?
  - b. Market value?
  - c. Effective date?
  - d. Marketing period?
  - e. Sales history of subject property?

- f. Reflect the valuation using the cost, income, and comparable sales approaches?
  - g. Evaluate and correlate the three approaches into a final value estimate, based on the appraiser's judgment?
  - h. Explain why an approach is inappropriate and not used in the appraisal?
  - i. Fully support the assumptions and the value rendered through adequate documentation?
16. Are staff appraisers independent of the lending, investment, and collection functions?
  17. Are fee appraisers engaged directly by the branch and do they have no direct or indirect interest, financial or otherwise, in the property or transaction?
  18. Are fee appraisers paid the same fee whether or not the loan is granted?
  19. If the transaction is outside the local geographic market of the branch, does the branch engage an appraiser with knowledge of the market where the real estate collateral is located?

## ENVIRONMENTAL LIABILITY

20. Do loan applicants provide information on environmental matters pertaining to their business facilities?
21. If the branch acquires a loan, either by purchase or participation, does it ensure that
  - adequate due diligence regarding environmental risk matters has been performed by the lead lender?

22. Do loans receive a Phase I Environmental Risk Report if the collateral is deemed to have a higher environmental risk potential than other types of real property?
23. Has senior management designated a specific "environmental risk analyst" who receives special training on environmental risk?
24. Are potential environmental problems noted in an environmental risk report considered by senior management prior to loan approval?
25. Are procedures established for reviewing collateral prior to foreclosure to ensure environmental risk has been addressed?
26. Are training programs conducted so that lending personnel are aware of environmental liability issues and are able to identify borrowers with potential problems?

## CONCLUSION

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

### INTRODUCTION

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 branch can promote commercial or residential development through its construction lending as well as receive significant profits over a relatively short time frame.

Inasmuch as construction lending is a form of interim financing, loan repayment is contingent upon the borrower either obtaining permanent financing or finding 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 branch 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 prior to or simultaneous 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.

### LENDING POLICY

Banks can limit the risk inherent in construction lending by establishing policies that specify the type and extent of branch involvement. The branch'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 construction progress.

### Lending Limits

A branch should establish 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 branch'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 section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 and included as appendix C of the Federal Reserve's Regulation H. These guidelines, and the accompanying LTV limits, are discussed in the Real Estate Loans section of this manual. Generally, the LTV ratio should not exceed the following supervisory guidance 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; and
- 85 percent for one- to four-family residential construction loans.

The foregoing limits apply only to domestic banks, not to FBOs; however, these guidelines are provided for reference.

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 of 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.
- An improper or lax monitoring of funds advanced by the branch.

## TYPES OF CONSTRUCTION LOANS

The basic types of construction loans are unsecured front money, land development, residential construction, and commercial construction loans. It is not uncommon for a branch 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 branch 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. Branch 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 branch from unforeseen events (such as unplanned expenses) that would otherwise jeopardize the branch'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 branch 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 branch should review sales projections to ensure that they are not overly optimistic. Additionally, branches 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 home buyer financing are usually limited to a predetermined number of speculative homes, which are permitted to get the project started. It is important to ensure that the home buyer has arranged permanent financing before the branch finances the construction; otherwise, the branch may find itself without a source of repayment. Construction loans without permanent takeout commitments generally should be aggregated to determine whether a concentration of credit exists, that is, in those situations when the amount exceeds the designated percentage of total assets. For further guidance in this area, examiners should consult with their respective agencies.

Proposals to finance speculative construction projects 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 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 branch 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 branch 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 branch'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 “takeout” 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 branch 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 branch may be forced into providing permanent financing, oftentimes in distressed situations. In evaluating this risk, the branch should consider whether the completed project will be able to attract extended-term financing, supported 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 in any real estate loan, the branch must obtain an appraisal or evaluation of the real estate in accordance with the Federal Reserve's Regulation H. 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 branch's assessment of the credit because the repayment of the loan becomes increasingly dependent on the sales program or leasing of the project.

The branch 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 branch 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, with contributions injected in the project in phases. A branch should assess the likelihood of the syndication being able to raise the necessary equity.

## BRANCH 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 branch 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 branch'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 the ability to 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 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 branch, 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 branch'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 preleasing requirements. For a loan with a takeout commitment, the financial strength and repayment history of the permanent lender should be analyzed. For a loan without a takeout commitment, or one where the construction lender provides the permanent financing for its construction loan, the long-term risks also need to be evaluated. Refer to the Real Estate Loans section in this manual, on the branch'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 branch 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 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 branch 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 branch should closely monitor the project before issuing a release to the partner/guarantor.

## BRANCH ASSESSMENT OF REAL ESTATE COLLATERAL

Branches should obtain an appraisal or evaluation, as appropriate, for all real estate-related financial transactions prior to making the final credit or other decision. Refer to the Real Estate Appraisals and Evaluations section of this manual for a description of the related requirements a branch must satisfy 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 necessary for an appraiser and evaluator, provides guidance on evaluations, and describes the three appraisal methods.

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. Additionally, the branch will normally request the appraiser to report the "as completed" value. 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.

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 documented 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 are unsubstantiated assumptions, the branch may request the appraiser or evaluator to provide a more detailed justification of the assumptions or obtain a new appraisal or evaluation. Since 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 branch to closely monitor the project's progress and value during the construction period. Refer to the Real Estate Loans section of the manual 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 to 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 multi-phase 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 and "hard" construction costs, as well as indirect or "soft" costs for construction loan interest, organizational and administrative cost, 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 branch 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 branch 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 branch 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 that 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 nec-

essary for processing and servicing the loan and protect the branch 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 branch 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 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 number of housing starts ahead of sales (speculative building). The starts ahead of sales, however, contain additional risk. If the branch 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 be in default at the time settlement occurs.

The commitment agreement, referred to as a buy/sell contract or a 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.

## LOAN ADMINISTRATION

The branch and the borrower 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 market 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 pre-established 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 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 branch 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. 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 branch 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 branch 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 branch 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 branch 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 branch 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 branch must be accurately informed of the progress to date in order to monitor the loan. It is also important that the branch ascertain whether draws are being taken in accordance with the predetermined disbursement schedule.

Before any draw amount is disbursed, however, the branch must obtain verification of continued title insurance. Generally, this means verifying that 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 branch 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 branch 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 branch 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 branch 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 pre-committed 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 branch would release its lien and cancel the note.

Additionally, as the commercial project is leased, the lender should ensure that the branch's position is protected in the event that extended-term funding is not obtained. The branch may require tenants to enter into subordination, attornment, and nondisturbance agreements, which protect the branch's interests in the lease by providing for the assumption of the land-

lord's position by the branch in the event the borrower declares bankruptcy. Furthermore, to ensure that the branch 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 branch must consider the alternatives available to recover its advances. For incomplete projects, the branch 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 branch 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 branch 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 branch, 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 branch to determine if trade payables are paid late or if there are any unpaid bills. In the event of problems, a branch 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 branch 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 consolidated 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 branch 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 available 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 branch'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 documented in writing and formally agreed to by the borrower. If additional collateral is accepted or substituted, the branch should ensure that the necessary legal documents are filed to protect the branch'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 branch 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 branches 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. This decline in 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 of 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 such a manner that is consistent with sound banking principles, supervisory guidelines, and accounting practices, which would protect the branch and improve its prospects for collecting or recovering on the asset.

# Real Estate Construction Loans

## Examination Objectives

Effective date July 1997

## Section 3110.2

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1. To determine if policies, practices, procedures, and internal controls regarding real estate construction loans are adequate.
2. To determine if branch officers are operating in conformance with the branch'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.

# Real Estate Construction Loans

## Examination Procedures

Effective date July 1997

## Section 3110.3

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 branch's construction lending activity.

1. Determine the scope of the examination based on the evaluation of internal controls and the work performed by internal/external auditors.
2. 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. Review management's actions taken in response to prior examination comments.
3. Review management reports on the status of construction lending activity, economic developments in the market, and problem loan reports.
4. Evaluate the branch with respect to:
  - a. the adequacy of written policies and procedures relating to construction lending.
  - b. operating compliance with established branch policy.
  - c. favorable or adverse trends in construction lending activity.
  - d. the accuracy and completeness of the branch'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 branch'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.
5. Select loans for examination, using an appropriate sampling technique. 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, 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.

6. 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 branch's liens.
    - determining if adequate hazard, builder's risks, and worker's compensation insurance is maintained.
  - d. Determine whether the 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 branch 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 or director of the branch or to 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.
7. In connection with the examination of other lending activity in the branch, the examiner should 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.
8. 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 credit.
  - m. classified loans.
  - n. violations of laws or regulations, and non-compliance with regulatory requirements.
  - o. action taken by management to correct previously noted deficiencies and corrective actions recommended to management at this examination, with the branch's response to such recommendations.

### POLICIES AND OBJECTIVES

1. Has the head office and branch management adopted and 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 branch, and are they compatible with changing market conditions?
  - public liability insurance?
  - completion insurance?
- b. the property owner's payment of real estate taxes?
4. Does the branch require that 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?
5. Does the branch employ standardized checklists to control documentation for individual files and perform audit reviews for adequacy?
6. Does the documentation file indicate all of the borrower's other loans and deposit account relationships with the branch and a summary of other construction projects being financed by other banks? Does the branch analyze the status of these projects and the potential effect on the borrower's financial position?
7. Does the branch use tickler files that:
  - a. control scheduling of inspections and disbursements?

### DOCUMENTATION

3. Does the branch require and maintain the following documentation:
  - a. the contractor's payment of:
    - employee withholding taxes?
    - builder's risk insurance?
    - worker's compensation insurance?

- b. assure prompt administrative follow-up on items sent for:
  - recording?
  - attorney's opinion?
  - expert review?
- 8. Does the branch 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. worker's compensation insurance?
  - d. public liability insurance?
- 16. Does the branch require that cost estimates of more complicated projects be reviewed by qualified personnel: experienced in-house staff, an architect, construction engineer, or independent estimator?
- 17. Are commitment fees required on approved construction loans?

## REVIEWING LOAN APPLICATIONS

- 9. Does branch policy require a personal guarantee from the borrower on construction loans?
- 10. Does branch policy require personal completion guarantees by the property owner and/or the contractor?
- 11. Does the branch require a construction borrower to contribute equity to a proposed project in the form of money or real estate? If so, indicate the form of equity contributed.
- 12. Does the project budget include the amount and source of the builder's and/or owner's equity contribution?
- 13. Does the branch 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?
- 14. 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?
- 15. Does the branch require an estimated cost breakdown for each stage of construction?
- 18. Is the construction loan agreement signed before an actual loan disbursement is made?
- 19. 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?
- 20. Does the branch require all change orders to be approved in writing by the:
  - a. branch?
  - b. branch'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?
- 21. Does the construction loan agreement set a date for project completion?
- 22. Does the construction loan agreement require that:
  - a. the contractor not start work until authorized to do so by the branch?
  - b. on-site inspections be permitted by the lending officer or an agent of the branch without prior notice?
  - c. disbursement of funds be made as work progresses, supported by documentation that the subcontractors are receiving

## CONSTRUCTION LOAN AGREEMENT

- payment and that the appropriate liens are being released?
- d. the branch 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 branch?
  - g. the contractor carry builder's risk and worker's compensation insurance? If so, has the branch 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?
23. In addition to the aforementioned points, does the construction loan agreement for residential tract construction loans require:
- a. branch authorization for individual tract housing starts?
  - b. periodic sales reports be submitted to the branch?
  - c. periodic reports on tract houses occupied under a rental, lease, or purchase option agreement be submitted to the branch?
  - d. limitations on the number of speculative houses and the completion of one tract prior to beginning another?
26. 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?
27. Does the branch 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?

## INSPECTION

28. Are inspection authorities noted in the:
- a. construction loan commitment?
  - b. construction loan agreement?
  - c. tri-party buy-and-sell agreement?
  - d. takeout commitment?
29. Are inspections conducted on an irregular basis?
30. Are inspection reports sufficiently detailed to support disbursements?
31. Are inspectors rotated from project to project?
32. Are spot checks made of the inspectors' work?
33. 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?

## COLLATERAL

24. Are liens filed on non-real estate construction improvements, i.e., personal property that is movable from the project?
25. When entering into construction loans, does the branch, 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 branch'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?

## DISBURSEMENTS

34. 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 branch employee who had no part in granting the loan?
  - e. compared to 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?

35. Does the branch obtain waivers of subcontractor's and mechanic's liens as work is completed and disbursements are made?
  36. Does the branch 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?
  37. Does the branch periodically review undisbursed loan proceeds to determine their adequacy to complete the projects?
  38. 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?
47. 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?
    - a. issue official checks or drafts?
    - b. handle cash?
    - c. reconcile subsidiary records to general ledger controls?
  48. 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?
  49. Are inquiries about construction loan balances received and investigated by persons who do not also handle cash?
  50. Are documents supporting recorded credit adjustments subsequently checked or tested by persons who do not also handle cash?
  51. Is a delinquent accounts report generated daily?
  52. Are loans in excess of supervisory LTV limits identified in the branch's records and are the aggregate amounts of such loans reported at least quarterly to the board of directors?
  53. Does the branch maintain a daily record summarizing note transaction details (loans made, payments received, and interest collected) to support applicable general ledger account entries?
  54. Are note and liability trial balances frequently reconciled to the general ledger by employees who do not process or record loan transactions?

## TAKEOUT COMMITMENT

39. Does counsel review takeout agreements for acceptability?
40. Does the branch obtain and review the permanent lender's financial statements to determine the adequacy of its financial resources to fulfill the takeout commitment?
41. Is a tri-party buy-and-sell agreement signed before the construction loan is closed?
42. Does the branch 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

43. Does the branch require completion insurance for all construction loans?
44. Has the branch established minimum financial standards for borrowers who are not required to obtain completion bonding? Are these standards observed in all cases?
45. Does counsel review completion insurance bonds for acceptability?

## LOAN RECORDS

46. Are the preparation, addition, and posting of subsidiary real estate construction loan

## LOAN INTEREST AND COMMITMENT FEES

55. 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?
56. Are any independent interest and fee computations made and compared or adequately

tested to loan interest by persons who do not also:

- a. issue official checks or drafts?
- b. handle cash?

this area? If not, indicate any additional examination procedures deemed necessary.

58. Based on the information gathered, evaluate the internal controls in this area (i.e. strong, satisfactory, fair, marginal, unsatisfactory).

## CONCLUSION

57. Is the information covered by this ICQ adequate for evaluating internal controls in

# Real Estate Construction Loans

## Audit Guidelines

Effective date July 1997

## Section 3110.5

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Refer to the Credit Risk Management, Audit Guidelines, section of this manual for items applicable to Real Estate Construction Loans.

1. Using appropriate sampling techniques, select loans from the trial balance and:
  - a. Review loan agreement provisions for hold back or retention, and determine if undisbursed loan funds and/or contingency or escrow accounts are equal to retention or holdback requirements.
  - b. If separate interest reserves are maintained, determine if debit entries to those accounts are authorized in accordance with the terms of the loan agreement and if they are supported by inspection reports, certificates of completion, individual bills, or other evidence.
  - c. Review disbursement ledgers and authorizations and determine if authorizations are signed according to the terms of the loan agreement.
  - d. Verify debits in the undisbursed loan proceeds accounts to inspection reports, individual bills, or other evidence supporting disbursements.

Some branches provide lending services to stock brokerage firms using stock of listed corporations as collateral. To promote efficiency in the pledging of collateral, the Stock Clearing Corporation, a wholly-owned subsidiary of the New York Stock Exchange, transfers stock ownership through computer book entries and thus eliminates the physical movement of the securities. The operating department of the Stock Clearing Corporation, Central Certificate Service (CCS), handles the technical aspects of that operation.

Brokerage firms deposit shares of eligible securities with CCS. The stock certificates representing those shares are registered in the name of a common nominee. CCS has physical control of the securities while they are on deposit. Loan arrangements are made between the broker and the lending branch with the broker instructing CCS, through written authorization, to debit the firm's account and credit that of the branch. CCS sends a copy of the authorization to the branch and will not reverse the entry or make partial withdrawals without written authorization from the branch. Participating financial institutions receive daily printouts, showing their position in the program by broker name and type of security. Because of adequately protected controls employed by Stock Clearing Corporation, examiners should accept the daily position printouts without further verification.

### COMMODITY LOANS

Loans to carry investments in commodities entail the same basic criteria as in all credit relation-

ships. Borrowers are typically nonproducers or nonprocessors of the commodity and include individuals, trading companies, manufacturers, or broker/dealers. The loan may represent a direct investment in the commodity or the carrying of a forward or futures position in the commodity. The commodity being purchased generally secures the borrowing. Common purposes for commodity loans include:

- The temporary holding by a trader of a commodity under contract for sale or in anticipation of sale in the near term.
- The holding of a commodity by an entity in anticipation of price appreciation for that commodity.
- The holding of a commodity by a manufacturer or fabricator awaiting transformation into some other product.

The focus of the examination of the branch's commodity lending area is on the lending policy and the control exercised over the collateral. The policy should address under what circumstances and conditions commodity loans will be made, particularly whether the branch will grant loans to finance a speculative position in a commodity. For secured loans, collateral margin requirements should be included in the policy.

Control of the collateral is important. Generally, the commodity will be held in a bonded warehouse, bank, or other depository institution. The branch should control title to the commodity. Because commodity markets can become volatile, collateral positions should be monitored frequently for compliance with the policy.

# Securities Broker and Dealer Loans

## Examination Objectives

Effective date July 1997

## Section 3120.2

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

# Securities Broker and Dealer Loans

## Examination Procedures

Effective date July 1997

## Section 3120.3

1. If selected for implementation, complete or update the Internal Control Questionnaire for this area.
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. Additionally, obtain a listing of any deficiencies noted in the latest review by internal/external auditors and determine if corrections have been accomplished.
4. Request the branch to supply:
  - a. Schedule of approved lines for each dealer, including outstanding balances.
  - b. Delinquent interest billings and date billed amount of past due interest.
5. Obtain a trial balance of all dealer accounts and:
  - a. Verify balances to departmental controls and the general ledger.
  - b. Review reconciling items for reasonableness.
6. Using an appropriate sampling 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 committee or any similar committee.
  - h. Reports furnished to the loan and discount committee or any similar committee.
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 commitments or contingent liabilities exceed the cutoff.
  - d. Select loans that 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 branch's collateral record onto the credit line sheets:
  - a. A list of collateral held, including date of entry and amount advanced.
  - b. A brief summary of the agreement between the branch 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 transactions with and for brokers and dealers are exempt from the margin restrictions of Regulation U. Refer to the regulation, which can be found in the Federal Reserve Regulatory Service, for a
  - i. Reports furnished to the head office.
  - j. Loans classified during the preceding examination.
  - k. A listing of loans charged off since the preceding examination.

- complete description of such transactions that 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. At this point, the examiner needs to decide whether further examination and testing is needed. If further work is warranted, refer to the audit guidelines. After reviewing the audit guidelines, proceed to step 13.
  13. Discuss with appropriate officer(s) and prepare summaries in appropriate report form of:
    - a. Delinquent loans.
    - 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.
  14. Prepare appropriate comments for the workpapers and the examiner-in-charge stating your findings with regard to:
    - a. The adequacy of written policies relating to securities broker and dealer loans.
    - b. The manner in which branch 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.
  15. Update the workpapers with any information that will facilitate future examinations.

# Securities Broker and Dealer Loans

## Internal Control Questionnaire

Effective date July 1997

Section 3120.4

Review the branch's internal control, policies, practices, and procedures for making and servicing loans. The branch'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 a policy been adopted specifically addressing securities broker and dealer loans that:
  - a. Establishes standards for determining broker and dealer credit lines?
  - b. Establishes 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 that 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 multi-copy, prenumbered records maintained that:
  - a. Detail the complete description of collateral pledged?
  - b. Are computer generated or typed?
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 T being considered in granting broker and dealer loans?
13. Concerning commodity lending:
  - a. Is control for the collateral satisfactory, i.e., stored in the branch's vault, another bank, or a bonded warehouse?
  - b. If collateral is not stored within the branch, are procedures in effect to ascertain the authenticity of the collateral?
  - c. Does the branch have a documented and recorded security interest in the proceeds of the future sale or disposition of the commodity and the existing collateral position?
  - d. Do credit files document that the financed positions are and remain fully hedged?
14. Concerning loans to commodity brokers and dealers:
  - a. Does the branch maintain a list of the major customer accounts of the brokers or dealers to whom it lends? If so, is the list updated on a periodic basis?
  - b. Is the branch aware of the broker/dealer's policy on margin requirements and the basis for valuing contracts for margin purposes, i.e., pricing spot versus future?
  - c. Does the branch attempt to ascertain whether the positions of the broker/dealer's clients that are indirectly financed by branch loans remain fully hedged?

**CONCLUSION**

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

# Securities Broker and Dealer Loans

## Audit Guidelines

Effective date July 1997

## Section 3120.5

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1. Verify the accuracy of the trial balance.
2. Test reconciling items to the extent considered necessary.
3. Using an appropriate sampling technique, select broker and dealer loans and:
  - a. Prepare and mail confirmation forms to dealers (information confirmed should include the loan balance and date of entry).
  - b. After a reasonable time period, mail second requests.
  - c. Follow up on any no-replies or exceptions, and resolve differences.
  - d. Obtain a list of the most recent broker and dealer interest billings and check calculation of interest report.
- e. Determine whether interest payments are delinquent and trace to inclusion in delinquency report.
- f. Determine that appropriate action has been taken to bring delinquent accounts to a current status.
4. Review collateral records and:
  - a. Determine the reason for differences between the branch's collateral records and the actual items held by the branch.
  - b. Investigate other differences to the extent considered necessary.

This section addresses securities activities in the broadest meaning of the term. It is divided into three sections: Investment Securities, Trading Securities, and Other, which includes resale and repurchase transactions.

### INVESTMENT SECURITIES

Since January 1, 1994, investment securities activities of branches are subject to FASB Statement No. 115 (Accounting for Certain Investments in Debt and Equity Securities). Under this standard, all branches are required to segregate their investment securities portfolios into three categories: (1) held-to-maturity, (2) available-for-sale, and (3) trading securities. The held-to-maturity category replaces the former held-for-investment category. The available-for-sale category is new, and the trading category is the same as before.

*Held-to-maturity (HTM) securities* are debt securities that the branch has both the intent and ability to hold until maturity. The branch will continue to report HTM securities at amortized cost.

*Available-for-sale (AFS) securities* are defined as debt or equity securities for which the branch does not have the positive intent and ability to hold to maturity, yet does not intend to trade actively as a part of its trading account. AFS securities transactions must be reported at fair value with any unrealized gains and losses reported directly as a separate component of equity capital. Thus, unrealized changes in these securities' value will have no effect on the reported earnings of the branch.

*Trading securities* are those debt and equity securities that a branch buys and holds principally for the purpose of selling in the near term. Trading securities will continue to be reported at fair market value with unrealized gains or losses reported directly in the income statement as a part of the branch's earnings.

This section will deal only with investment securities, or those categorized as HTM and AFS. A complete discussion of trading securities is contained in the Federal Reserve's *Trad-*

*ing Activities Manual*. Additional reference material includes:

- FFIEC's Supervisory Policy Statement on Securities Activities as of January 10, 1992.
- SR 93-69—"Risk Management and Internal Controls for Trading Activities of Banking Organizations."
- SR 95-17—"Evaluating the Risk Management and Internal Controls of Securities and Derivative Contracts Used in Nontrading Activities."

The rationale behind FASB creating the AFS category and allowing institutions to report AFS securities at fair value is that it presents a more accurate and realistic picture of an institution's financial condition. The inclusion of net unrealized gains and losses with Tier 1 capital provides incentives to institutions to hold securities that have depreciated or appreciated in value, thereby reducing market volatility. However, although market volatility is reduced, bank's capital ratios are subject to increased volatility since their assets will be marked-to market while liabilities remain at book value.

In addition to any restrictions imposed by state law or regulation, under Section 7(c)(2) of the International Banking Act of 1978, all branches may only hold the types of investment securities that may be held by national banks and state member banks. See 12 USC 24(7); 12 CFR Part 1. State-licensed branches, additionally, may only hold those types of investment securities permitted under state law. It should be noted that branches must obtain Federal Reserve approval, before commencing commodity or equity-linked transactions. See 12 CFR 208.128 (made applicable to branches by 12 USC 3105(c)(2)).

For branches, investment securities include U.S. government obligations and certain domestic corporate debt securities; as well as various federal agency bonds; state, county, and municipal issues; special revenue bonds; and industrial revenue bonds. Securities included in the investment account should provide a reasonable rate of return as well as provide the necessary liquidity the branch requires. Accordingly, an investment account should contain some securities that may be quickly converted into cash by sale or by maturity. Hence, liquidity and marketability are of the utmost importance. A bond

is a liquid asset if its maturity is short and if there is reasonable assurance that it will be paid at maturity. It is marketable if it may be sold quickly at a price commensurate with its yield and quality. The highest quality bonds have either or both of those two desirable qualities.

Occasionally, it may be difficult to distinguish between a loan and a security. Loans generally result from direct negotiations between a borrower and a lender. A branch may refuse to grant a loan unless it and the borrower can agree to terms. A security, on the other hand, is usually acquired through a third party, a broker or dealer in securities. Most securities have standardized terms, which can be compared to the terms of other market offerings. Because the terms of most loans do not lend themselves to such comparison, the average investor may not accept the terms of the lending arrangement. Thus, an individual loan cannot be regarded as a readily marketable security.

An interesting hybrid between a security and a loan is a private placement. A private placement is a security transaction whereby the issuer did not involve any "public offering" but rather offered the securities privately. The securities are not reviewed by the SEC, and are offered and sold only to those parties who the issuer believes are (1) sufficiently experienced to evaluate merits and risks of the investment, or (2) able to bear the risk of the investment. Through negotiation, both parties may tailor the offering to meet their needs. The issuer saves securities registration costs and the investor makes an investment for a specified length of time at a stated rate of return. Both investor and issuer complete the transaction privately without being subject to regulatory and public scrutiny. The major disadvantage of private placements is the lack of a secondary market, and therefore it may be highly illiquid. Although private placements have many characteristics of loans, for regulatory reporting purposes they are considered securities.

## INVESTMENT POLICY

The branch should have an investment policy, which was developed in conjunction with and approved by its head office, to control and monitor the branch's investment activities. This policy should include guidelines for personnel involved in securities activities.

The basic objectives of a sound investment policy are the same for all financial institutions but the emphasis placed on each objective will vary, according to the individual branch's needs. The basic objectives include:

- Minimizing risks.
- Generating a favorable return on investments, without undue compromise of the other objectives.
- Providing for and managing liquidity.
- Meeting any applicable pledge requirements.
- Temporary use of excess funds.

The investment policy must encompass more than a philosophical description of objectives. If policy development is delegated to local branch management, the examiner should verify that head office management has reviewed or is aware of the policy and the branch's level of compliance.

## TYPES OF INVESTMENT SECURITIES

The investment policy should include guidelines on the quality and quantity of each type of security to be held. Credit quality is of major importance.

*U. S. government obligations* are the highest quality investments and are the most readily marketable. They are riskless from a credit standpoint but are subject to price fluctuations because of changes in money market interest rates. Longer-term issues tend to fluctuate more widely than shorter-term issues. All things being equal, maturity, credit, etc., smaller coupon securities are more volatile than larger coupon securities.

*Federal agency securities* are also of very high quality. Similar investments that enjoy wide acceptance in the banking community are U.S. government guaranteed public housing authority issues. New housing authority and public housing authority notes or bonds generally provide the investor with tax exempt income and a full faith and credit guaranty of the U.S. government.

Other *tax exempt bonds* have varying levels of indirect U.S. government support. Pre-refunded

or escrowed bonds are often fully and directly secured by obligations issued by or otherwise supported by the full faith and credit of the United States. Certain municipal housing bonds are partially payable from rental subsidies and/or mortgage credit insurance provided by federal agencies. Pools of partially guaranteed student loans are sometimes pledged for payment of municipal higher education bonds. There are numerous programs that provide federal backing for municipal bonds. Care must be taken to distinguish between those issues that are federally guaranteed and those that are not.

*High quality municipal bonds* frequently are desirable because of their tax exempt status. Many municipal bonds, however, possess an

unfavorable market aspect. Except for high quality issues of larger municipalities, municipal bonds often are not readily marketable and, as a result, may produce sizeable spreads between bid and ask prices. The spread may be so wide, it may cost the selling bank a sizeable portion of a year's interest.

## BOND RATINGS

Monthly rating service publications are useful in determining the investment quality of municipal and corporate obligations. The standard bond rating symbols, as shown on the following page, are listed in the order of their credit quality.

<i>Standard &amp; Poor's</i>	<i>Moody's</i>	<i>Description</i>
<i>Bank Quality Investments</i>		
AAA	Aaa	Highest grade obligations.
AA	Aa	High grade obligations
A	A-1, A	Upper medium grade
BBB	Baa-1, Baa	Medium grade, on the borderline between definitely sound obligations and those containing predominantly speculative elements. Generally, the lowest quality bond that may qualify for bank investment.
<i>Speculative and Defaulted Issues (High Yield or Noninvestment Grade)</i>		
BB	Ba	Lower medium grade with only minor investment characteristics.
B	B	Low grade, default probable.
Ccc, cc, c, D	Caa, Ca, C	Lowest rated class, may be in default, extremely poor material prospects.
<i>Provisional or Conditional Rating</i>		
Rating-P	Con. (Rating)	Debt service requirements are largely dependent on reliable estimates as to future events.

Although the analyses of major rating agencies are basically sound and updated frequently, it should be kept in mind that ratings are only evaluations of probabilities. In order to determine appropriate credit limits to a particular counterparty, bond ratings should be supplemented by the branch's own credit analysis of the issuer.

Sub-investment-quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group includes securities in grades below the four

highest grades and unrated securities of equivalent quality, defaulted securities and sub-investment-quality stocks. As noted in the following chart, securities in grades below the four highest grades and unrated securities of equivalent quality will be valued at market price. The market value will be classified substandard, and the depreciation will be classified doubtful. Depreciation in defaulted securities and sub-investment-quality stocks will generally be classified loss; market value will be classified substandard.

## SECURITY CLASSIFICATIONS

<i>Type of Security</i>	<i>Classification</i>		
	<i>Substandard</i>	<i>Doubtful</i>	<i>Loss</i>
Investment-quality	XXX	XXX	XXX
Sub-investment-quality, except—	Market Value	Market Depreciation	XXX
Sub-investment-quality, municipal general obligations	Book Value	XXX	XXX
Defaulted securities and sub-investment-quality stocks, except—	Market Value	XXX	Market Depreciation
Defaulted municipal general obligations:			
Interim	XXX	Book Value	XXX
Final, i.e., when market is reestablished	Market Value	XXX	Market Depreciation

As a matter of policy, an institution should not acquire securities until it has assessed the creditworthiness of the issuer and determined that the risk exposure conforms with its policies. At a minimum, the examiner should expect such a policy to require credit reviews on all transactions before purchase, annual internal credit reviews, and more frequent credit updates on all nonrated issues, municipal obligations with a credit rating that has declined, special revenue and other debt obligations with limited or no marketability, speculative and defaulted issues,

and stocks acquired through DPC transactions. Credit analysis is always necessary to determine if an investment is appropriate for the branch to own. According to Federal regulation (12 CFR, Section 1.8) it is incumbent upon management to demonstrate that it has exercised prudence in acquiring all investment securities.

The examiner should be mindful, however, that as part of a larger organization, the branch may operate soundly outside of the parameters normally considered acceptable due to its unique role within the FBO's network. When traditional

liquidity analysis results in unsatisfactory findings, the examiner should discuss with management the influence of the branch's relationships with related offices.

Policy guidelines for risk diversification should be formulated in conformity with legal and prudent investment restrictions. Concentrations resulting from the obligations of a single or related issuer, credit ratings, geographic and type distribution may all be compatible with sound investment policy. In many cases, concentrations would not be considered unwarranted but, in all cases, it is essential that investment concentrations be monitored at the head office level.

The investment policy should also take into consideration the applicable federal and state income tax laws. Finally, the investment portfolio should be reviewed at least annually by head office management and quarterly by senior officers of the branch. Sufficient analytical data must be provided to allow head office management to make an informed judgment of the investment policy's effectiveness. Such reviews should consider the information discussed in this section and the current market value of the portfolio.

Management should maintain clear lines of authority and responsibility for acquiring securities and managing risk. This includes setting appropriate limits on risk taking, creating adequate systems for measuring risk, providing effective internal controls, and implementing a comprehensive risk reporting and risk management review process.

## TRADING SECURITIES

The following section deals with securities portfolio trading but does not include derivative-related activity. For an in-depth discussion of derivative-related activity, refer to the Federal Reserve's *Trading Activities Manual*.

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which, when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the branch's income and a filing of false regulatory reports. It is an unsafe

and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards that are intended for investment portfolio transactions; therefore, the discipline associated with accounting standards applicable to trading accounts is necessary. Securities held in trading accounts must be periodically marked-to-market with unrealized gains or losses recognized in current income. Prices used in periodic revaluations should be obtained from sources that are independent of the securities dealer doing business with the branch.

## Covered Calls

The writing of covered calls is an option strategy that, for a fee, grants the buyer of the call option the right, but not the obligation to purchase a security owned by the option writer at a pre-determined price before a specified future date. The option fee<sup>1</sup> received by the writing (selling) depository institution provides income and has the effect of increasing the effective yield on the portfolio asset "covering" the call.

Covered call programs have been promoted as hedging strategies because the fee received by the writer can be used to offset a limited amount of potential loss in the price of the underlying security. If interest rates rise, the call option fee can be used to partially offset the decline in the market value of a fixed rate security or the increased cost of market rate liabilities used to carry the security. However, there is no assurance that an option fee will completely offset the price decline on the security or the increased cost of liabilities and the resulting reduced spread between the institution's return on assets and funding costs.

As a practical matter, the gain on a security covered by a written call is limited to the amount of the difference between the carrying value of the security and the strike price at which the security will be called away. The potential for losses on the covered security is not similarly limited. In an effort to obtain higher yields, some portfolio managers have mistakenly relied on the theoretical hedging benefits of

1. Recognition of option fee income should be deferred until the option is exercised or expires. The covered call writer shall value the option at the lower of cost or market value at each report date.

covered call writing, and have purchased extended maturity U.S. government or Federal agency securities. This practice can significantly increase risks taken by the branch by contributing to a maturity mismatch between its assets and its funding.

Institutions should only initiate a covered call program for securities when head office and branch management have specifically approved a policy permitting this activity. This policy must set forth specific procedures for controlling covered call strategies, including recordkeeping, reporting, and review of activity, as well as providing for appropriate management information systems to report the results. Since the purchaser of the call acquires the ability to call the security away from the institution that writes the option, the ability of that institution to continue to hold the security rests with an outside party. Securities held to maturity against which call options have been written should therefore be redesignated as available for sale and reported at fair value. However, when the option contract requires the writer to deliver held-to-maturity securities, or when management has a pattern of practice of delivering held-to-maturity securities when called, management's intent to hold other securities to maturity may be called into question.

However, if an option contract requires the writer to settle in cash, rather than delivering an investment portfolio security, the institution writing the option maintains the ability to hold the security and, thus, the security may be reported as held-to-maturity. In this case, the option must still be reported at fair value.

## Adjusted Trading

Adjusted trading is a practice involving the sale of a security to a broker or dealer at a price above the prevailing market value and the simultaneous purchase and booking of a different security, frequently a lower grade issue or one with a longer maturity, at a price greater than its market value. Thus, the broker or dealer is reimbursed for losses on the purchase from the institution and ensured a profit. Such transactions inappropriately defer the recognition of losses on the security sold and establish an excessive reported value for the newly acquired security. Consequently, such transactions are prohibited and may be in violation of 18 USC

sections 1001-False Statements or Entries and 1005-False Entries.

## Coupon Stripping

Coupon stripping involves detaching unmatured coupons from securities and selling either the coupons or the remaining stripped security. Such transactions are often motivated by anxiety for immediate income recognition or by tax considerations. This practice significantly diminishes the worth, marketability, and liquidity of the securities.

U.S. government obligations are the most common type of security used for coupon stripping. Corporate or municipal issues may be used but are not viewed as attractive alternatives because of credit risk and early redemption features.

The Internal Revenue Service has ruled that the proceeds from the sale of unmatured coupons constitute ordinary income and are included in the taxable income for the year in which the sale occurred. A branch can increase current period taxable income to utilize a prior year's tax loss carry-forward by selling all or a portion of the unmatured coupons of their securities. Similarly, an ex-coupon security may be sold at its discounted value. The difference between the sale proceeds and the cost basis of the security is recognized as a current period tax loss.

There are a limited number of dealers that participate in wholesale and retail trading and reoffering of detached coupons and ex-coupon securities. That activity is generally viewed as inappropriate for branch dealers; the marketability and liquidity shortcomings attendant with either the coupons or the securities result in uncertain suitability for customer purchase without complete customer disclosure and consent. Ex-coupon securities or stripped coupons are distinctly different from securities that have all the unmatured coupons attached. The ex-coupon security and resulting coupons generally:

- Have a diminished and uncertain market value and impaired practical liquidity.
- Are not, absent adequate customer disclosure, suitable for sale to customers or as repurchase agreement collateral with customers.
- Are not considered good delivery items by securities dealers.

If a branch has engaged or elects to engage in such transactions, they must be reported as follows:

- The book value must be allocated between the principal portion and the coupons at the time the security is divided. This allocation will be based upon the present value of each component (principal and coupons) at the time of sale using the yield to maturity at the time the security was purchased as the discount rate.
- The profit or loss on the portion sold must be recognized during the period in which the sale occurred as other income or other expense. It will be the difference between that portion of the book value, allocated as above to the portion sold, and the actual selling price of that portion. The portion retained will be carried on the books of the branch at its allocated portion of the book value. Detached coupons or principal portions held by a branch, either as a result of purchase or of stripping securities held for its own account, will be reported as other notes, bonds and debentures, and not as U.S. Treasury securities, obligations of other U.S. government agencies and corporations, or obligations of states and political subdivisions in the United States.

### Special Guidance on Mortgage-Backed Products

Some mortgage-backed products exhibit considerably more price volatility than mortgages. Some mortgage pass-through securities can expose investors to significant risk of loss if not managed in a safe and sound manner. This price volatility is caused in part by the uncertain cash flows that result from changes in the prepayment rates of the underlying mortgages.

In addition, because these products are complex, a high degree of technical expertise is required to understand how their prices and cash flows may behave in various interest rate and prepayment environments. Moreover, because the secondary market for some of these products can be relatively thin, they may be difficult to liquidate should the need arise. Finally, there is additional uncertainty because new variants of these instruments continue to be introduced and their price performance under varying market and economic conditions has not been tested.

### General Guidance

Under the FFIEC policy statement, the banking agencies call for special management of mortgage-backed products. A general principle underlying this policy is that mortgage-backed products possessing average life or price volatility in excess of a benchmark fixed rate 30-year mortgage-backed pass-through security are “high-risk mortgage securities” and are not suitable investments. All high-risk mortgage securities, defined later in this section, acquired by depository institutions after February 10, 1992, must be carried in the institution’s trading account or as assets available for sale. Mortgage-backed products that do not meet the definition of a high-risk mortgage security at the time of purchase may be reported as held to maturity, available for sale, or held for trading, as appropriate. Branches must ascertain no less frequently than annually whether such products have become high-risk mortgage securities.

Branches generally should hold mortgage-backed products that meet the definition of a high-risk mortgage security only to reduce interest rate risk in accordance with safe and sound practices.<sup>2</sup> Furthermore, depository institutions that purchase high-risk mortgage securities must demonstrate that they understand and are effectively managing the risks associated with these instruments. Levels of activity involving high-risk mortgage securities should be reasonably related to a branch’s capacity to absorb losses, and level of in-house management sophistication and expertise. Appropriate managerial and financial controls must be in place and the branch must analyze, monitor, and prudently adjust its holdings of high-risk mortgage securities in an environment of changing price and maturity expectations.

Prior to taking a position in any high-risk mortgage security, branch management should conduct an analysis to ensure that the position will reduce the overall interest rate risk. Liquidity

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2. Notwithstanding the provisions of the Board’s supervisory policy generally requiring that high-risk mortgage securities be used only for the purpose of reducing interest rate risk, this supervisory policy is not meant to preclude an institution with strong capital and earnings and adequate liquidity that has a closely supervised trading department from acquiring high-risk mortgage securities for trading purposes. The trading department must operate in conformance with well-developed policies, procedures, and internal controls, including detailed plans prescribing specific position limits and control arrangements for enforcing these limits.

and price volatility of these products also should be considered prior to purchasing them. Circumstances in which the purchase or retention of high-risk mortgage securities is deemed by the appropriate regulatory authority to be contrary to safe and sound practices for depository institutions will result in criticism by examiners, who may require the orderly divestiture of high-risk mortgage securities. Purchases of high-risk mortgage securities prior to February 10, 1992, generally will be reviewed in accordance with previously-existing supervisory policies.

Securities and other products, whether carried on or off the balance sheet (such as CMO swaps, but excluding servicing assets), having risk characteristics similar to high-risk mortgage securities will be subject to the same supervisory treatment as high-risk mortgage securities.

Long-term zero coupon bonds also exhibit significant price volatility and may expose an institution to considerable risk. Disproportionately large holdings of these instruments may be considered an imprudent investment practice, which will be subject to criticism by examiners. In such instances, examiners may seek the orderly disposal of some or all of these securities. Assets slated for disposal are to be reported as assets available for sale at their market value.

### *Definition of "High-Risk Mortgage Security"*

In general, any mortgage-backed product that exhibits greater price volatility than a benchmark fixed rate thirty-year mortgage-backed pass-through security will be deemed to be high risk. For purposes of the FFIEC policy statement, a "high-risk mortgage security" is defined as any mortgage-backed product that at the time of purchase, or at a subsequent testing date, meets any of the following tests.<sup>3</sup> In general, a mortgage derivative product that does not meet any of the three tests below will be considered to be a "nonhigh-risk mortgage security."

- **Average Life Test.** The mortgage-backed product has an expected weighted average life greater than 10.0 years.

3. When the characteristics of a mortgage derivative product are such that the first two tests cannot be applied (such as with IOs), the mortgage derivative product remains subject to the third test.

- **Average Life Sensitivity Test.** The expected weighted average life of the mortgage-backed product:
  - Extends by more than 4.0 years, assuming an immediate and sustained parallel shift in the yield curve of plus 300 basis points, or
  - Shortens by more than 6.0 years, assuming an immediate and sustained parallel shift in the yield curve of minus 300 basis points.
- **Price Sensitivity Test.** The estimated change in the price of the mortgage-backed product is more than 17 percent, due to an immediate and sustained parallel shift in the yield curve of plus or minus 300 basis points.<sup>4</sup>

In applying any of the above tests, all of the underlying assumptions (including prepayment assumptions) for the underlying collateral must be reasonable. All of the assumptions underlying the analysis must be available for examiner review. For example, if an institution's prepayment assumptions differ significantly from the median prepayment assumptions of several major dealers as selected by examiners, the examiners may use these median prepayment assumptions in determining if a particular mortgage backed product is high risk.

The above tests may be adjusted to consider significant movements in market interest rates, to fairly measure the risk characteristics of new mortgage-backed products, and to take such action that is deemed appropriate to prevent circumvention of the definition of a high-risk mortgage security and other such standards.

Generally, a CMO floating-rate debt class will not be subject to the average life and average life sensitivity tests described above if it bears a rate that, at the time of purchase or at a

4. When performing the price sensitivity test, the same prepayment assumptions and same cash flows that were used to estimate average life sensitivity must be used. The only additional assumption is the discount rate assumption.

First, assume that the discount rate for the security equals the yield on a comparable average life U.S. Treasury security plus a constant spread. Then, calculate the spread over Treasury rates from the bid side of the market for the mortgage derivative product. Finally, assume the spread remains constant when the Treasury curve shifts up or down 300 basis points. Discounting the aforementioned cash flows by their respective discount rates estimates a price in the plus and minus 300 basis point environments.

The initial price will be determined by the offer side of the market and used as the base price from which the 17 percent price sensitivity test will be measured.

subsequent testing date, is below the contractual cap on the instrument. (An institution may purchase interest rate contracts that effectively uncapped the instrument.) For purposes of this policy statement, a CMO floating-rate debt class is a debt class whose rate adjusts at least annually on a one-for-one basis with the debt class's index. The index must be a conventional, widely-used market interest rate index such as the London Interbank Offered Rate (LIBOR). Inverse floating rate debt classes are not included in the definition of a floating rate debt class.

### *Supervisory Policy for Mortgage-Backed Products*

Prior to purchase, a branch must determine whether a mortgage-backed product is high-risk. A prospectus supplement or other supporting analysis that fully details the cash flows covering each of the securities held by the institution should be obtained and analyzed prior to purchase and retained for examiner review. In any event, a prospectus supplement should be obtained as soon as it becomes available.

### *Nonhigh-Risk Mortgage Securities*

Mortgage-backed products that do not meet the definition of high-risk mortgage securities, at the time of purchase, should be reported as held to maturity, available for sale, or held for trading, as appropriate. Branches must ascertain and document prior to purchase and no less frequently than annually thereafter that nonhigh-risk mortgage securities that are held to maturity remain outside the high-risk category. If a branch is unable to make these determinations through internal analysis, it must use information derived from a source that is independent of the party from whom the product is being purchased. Standard industry calculators used in the mortgage-related securities market place are acceptable and are considered independent sources. In order to rely on such independent analysis, institutions are responsible for ensuring that the assumptions underlying the analysis and the resulting calculation are reasonable. Such documentation will be subject to examiner review.

A mortgage-backed product that was not a high-risk mortgage security when it was purchased as an investment may later fall into the

high-risk category. When this occurs, the branch may continue to designate the mortgage-backed product as held to maturity, providing that management still maintains the positive intent and ability to hold the security to maturity. Furthermore, examiners should consider any unrecognized net depreciation in held-to-maturity high-risk securities when reviewing earnings and evaluating liquidity risk.

Once a mortgage-backed product has been designated as high-risk, it may be redesignated as nonhigh-risk only if, at the end of two consecutive quarters, it does not meet the definition of a high-risk mortgage security. Upon redesignation as a nonhigh-risk security, it does not need to be tested for another year.

### *High-Risk Mortgage Securities*

A branch may, generally, only acquire a high-risk mortgage backed product to reduce its overall interest rate risk. (Branches meeting the previously mentioned guidance regarding the use of these securities in a trading account may also purchase these securities for trading purposes.) A branch that has acquired high-risk mortgage securities to reduce interest rate risk needs to frequently assess its interest rate risk position and the performance of these securities. Since interest rate positions constantly change, a branch may determine that these high-risk mortgage securities no longer reduce interest rate risk. Therefore, mortgage backed products that are high-risk when acquired shall not be reported as held-to-maturity securities at amortized cost.

In appropriate circumstances, examiners may seek the orderly divestiture of high-risk mortgage securities that do not reduce interest rate risk. Appropriate circumstances are those in which the examiner determines that continued ownership of high-risk mortgage securities represents an undue safety and soundness risk to the branch. This risk can arise from the size of the branch's holdings of high-risk mortgage securities in relation to its earnings and head office capital, management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash flow risks of these securities, management's inability to prudently manage its overall interest rate risk, or similar factors.

A branch that owns or plans to acquire

high-risk mortgage securities must have a monitoring and reporting system in place to evaluate the expected and actual performance of such securities. The institution must conduct an analysis that shows that the proposed acquisition of a high-risk mortgage security will reduce the institution's overall interest rate risk. Subsequent to purchase, the branch must evaluate at least quarterly whether this high-risk mortgage security has actually reduced interest rate risk.

The branch's analyses performed prior to the purchase of high-risk mortgage securities and subsequently thereafter must be fully documented and will be subject to examiner review. This review will include an analysis of all assumptions used by management regarding the interest rate risk associated with the branch's assets, liabilities and off-balance sheet positions. Analyses performed and records constructed to justify purchases on a post-acquisition basis are unacceptable and will be subject to examiner criticism. Reliance on analyses and documentation obtained from a securities dealer or other outside party without internal analyses by the institution are unacceptable and reliance on such third-party analyses will be subject to examiner criticism.

Management should also maintain documentation demonstrating that it took reasonable steps to assure that the prices paid for high-risk mortgage securities represented fair market value. Generally, price quotes should be obtained from at least two brokers prior to executing a trade. If, because of the unique or proprietary nature of the transaction or product, or for other legitimate reasons, price quotes cannot be obtained from more than one broker, management should document the reasons for not obtaining such quotes.

In addition, a branch that owns high-risk mortgage securities must demonstrate that it has established the following:

- A head office approved portfolio policy which addresses the goals and objectives the branch expects to achieve through its securities activities, including interest rate risk reduction objectives with respect to high-risk mortgage securities;
- Limits on the amounts of funds that may be committed to high-risk mortgage securities;
- Specific financial officer responsibility for and authority over securities activities involving high-risk mortgage securities;
- Adequate information systems;

- Procedures for periodic evaluation of high-risk mortgage securities and their actual performance in reducing interest rate risk; and
- Appropriate internal controls.

The branch's senior management should regularly (at least quarterly) review all high-risk mortgage securities to determine whether these instruments are adequately satisfying the interest rate risk reduction objectives set forth in the portfolio policy. The branch's senior management should be fully knowledgeable about the risks associated with prepayments and their subsequent impact on its high-risk mortgage securities. Failure to comply with this policy will be viewed as an unsafe and unsound practice.

## OTHER MORTGAGE-BACKED PRODUCTS

There are advantages and disadvantages in owning these products. A branch must consider the liquidity, marketability, pledgeability, and price volatility of each of these products before investing in them. It may be unsuitable for a branch to commit significant amounts of funds to long-term stripped mortgage-backed securities, residuals, and zero coupon bonds, which fluctuate greatly in price.

### *Stripped Mortgage-Backed Securities*

Stripped mortgage backed securities (SMBS) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flows from the underlying mortgage-backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100 percent of the interest cash flows, and a principal-only (PO) strip, where the investor receives 100 percent of the principal cash flows.

All IOs and POs have highly volatile price characteristics based, in part, on the prepayment of the underlying mortgages and consequently on the maturity of the stripped security. Generally, POs will increase in value when interest rates decline, while IOs increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve, theoretically, to offset the interest rate risk associated with mortgages and

similar instruments held by a branch. Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO, the investor is speculating on the movements of future interest rates and how these movements will affect the prepayment of the underlying collateral. Furthermore, those SMBS that do not have the guarantee of a government agency or a government-sponsored agency as to the payment of principal and interest have an added element of credit risk.

As a general rule, SMBS cannot be considered as suitable investments for all branches. SMBS, however, may be appropriate holdings for branches that have highly sophisticated and well-managed securities portfolios, mortgage portfolios, or mortgage banking functions. In such branches, however, the acquisition of SMBS should be undertaken only in conformance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing these limits. These plans should be approved by head office management and their terms should be vigorously enforced.

Some branches may account for their SMBS holdings in accordance with Financial Accounting Standards Board Statement Number 91 (FASB No. 91), which requires that the carrying amount be adjusted when actual prepayment experience differs from prepayment estimates. Other branches may account for their SMBS holdings at market value or the lower of cost or market value.

## Asset-Backed Securities Residuals

Residuals are the excess of cashflows from asset-backed securities (ABS) transactions after the payments due to the bondholders and the trust administrative expenses have been satisfied. This cashflow is extremely sensitive to prepayments and thus has a high degree of interest rate risk.

Generally, the value of residual interests in ABS rises when interest rates rise. Theoretically, a residual can be used as a risk management tool to offset declines in the value of fixed-rate mortgage or ABS portfolios. However, it should be understood by all residual interest purchasers that the yield on these instruments is inversely related to their effectiveness as a risk manage-

ment vehicle. In other words, the highest yielding ABS residuals have limited risk management value due to a complicated ABS structure and/or unusual collateral characteristics that make modeling and understanding the economic cashflows difficult. Alternatively, those residuals priced for modest yields generally have positive risk management characteristics.

In conclusion, it is important to understand that a residual cashflow is highly dependent upon the prepayments received. Caution should be exercised when purchasing a residual interest, especially higher yielding interests, because the risk associated over the life of the ABS may warrant an even higher return in order to adequately compensate the investor for the interest rate risk assumed. Purchases of these equity interests should be supported by in-house evaluations of possible rate of return ranges in combination with varying prepayment assumptions.

Holdings of ABS residuals should be accounted for in the manner discussed under stripped mortgage-backed securities and should be reported as Other Assets on regulatory reports.

## Other Zero Coupon or Stripped Products

The interest and/or principal portions of U.S. government obligations are sometimes sold in the form of stripped coupons, stripped bonds (principal), STRIPS, or propriety products, such as CATS or TIGRs. Original issue discount bonds (OIDs) have also been issued by a number of municipal entities. Longer maturities of these instruments can exhibit extreme price volatility. Accordingly, disproportionately large, long-maturity holdings (in relation to the total portfolio) of zero coupon securities may be unsuitable for investment holdings for financial institutions.

## STRUCTURED NOTES

This sub-section highlights the growing use of structured notes by banking organizations and the need for examiners to ensure that banks that hold these instruments do so according to their own investment policies and procedures and with a full understanding of the risks and price sensitivity of these instruments under a broad range of market conditions. Some of these

instruments can expose investors to significant losses as interest rates, foreign exchange rates, and other market indices change. Accordingly, examiners should be mindful of these securities, whether they are used in a branch's trading, investment, or trust activities.

Structured notes, many of which are issued by U.S. government agencies, government-sponsored entities, and other organizations with high credit ratings, are debt securities whose cashflows are dependent on one or more indices in ways that create risk characteristics of forwards or options. They tend to have medium term maturities and reflect a wide variety of cashflow characteristics that can be tailored to the needs of individual investors.

As previously noted, the federal bank regulatory agencies have established price and effective maturity standards for mortgage-backed products based on specified scenarios. Institutions should ensure that they meet these regulatory requirements and should employ similar techniques in controlling the exposures of structured notes. The scenarios specified for assessing the market risk of these 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 non-parallel shifts in structure to evaluate potential basis, volatility and yield curve risks.

Structured notes may offer certain advantages over other financial instruments used to manage market risk. In particular, they may reduce counterparty credit risk, offer operating efficiencies and lower transaction costs, require fewer transactions, and address more specifically an institution's risk exposures. Risk to principal is typically small. Accordingly, when they are analyzed and managed properly, structured notes can be acceptable investments and trading products for banks.

Structured notes, however, can also have characteristics that cause them to be inappropriate holdings for many institutions. They can have substantial price sensitivity; they can be complex and difficult to evaluate; and they may also reflect high amounts of leverage relative to fixed income instruments with comparable face values. Their customized features and embedded options may also make them difficult to price and can reduce their liquidity. Consequently, branches considering the purchase of structured notes should determine whether these

factors are compatible with their investment horizons and with their overall portfolio strategies.

There are a wide variety of structured notes, with names such as single- or multi-index floaters, inverse floaters, index-amortizing notes, step-up bonds, and range bonds. These simple, though sometimes cryptic, labels can belie the potential complexity of these notes and their possibly volatile and unpredictable cashflows, which can involve both principal and interest payments. Some notes employ "trigger levels," at which cashflows can change significantly, or caps or floors, which can also substantially affect their price behavior.

The critical factor for examiners to consider is the ability of management to understand the risks inherent in these instruments and to manage the market risks of their institution in a satisfactory manner. Therefore, examiners should evaluate the appropriateness of these securities branch-by-branch, with a knowledge of management's expertise in evaluating such instruments, the quality of the institution's relevant information systems, and the nature of its overall exposure to market risk. This evaluation may include a review of the institution's ability to conduct stress tests. Failure of management to understand adequately the dimensions of the risks in these and similar financial products can constitute an unsafe and unsound practice for banks.

When making investment decisions, some institutions may focus only on the low credit risk and favorable yields of these notes and either overlook or underestimate their market and liquidity risks. Consequently, where these notes are material, examiners should discuss their role in the institution's risk management process and assess management's recognition of their potential volatility.

## OTHER

### Resale and Repurchase Agreement Activities (REPOS)

Repos typically involve short-term U.S. government securities purchased for the branch's own account or acquired under an agreement to resell and then sold under the counterparties agreement to repurchase. The rate of interest received and paid is generally dictated by prevailing market rates. Profits are based on a small spread

between interest earned and interest paid. Since both the profit margin and inherent risk are minimal, repos are generally used to satisfy a branch's short-term funding needs. A branch may attempt to improve profits by increasing the volume of such transactions by using the proceeds of completed transactions to finance an inventory of assets to be used in further repurchase arrangements. An alternative method of increasing profits is to increase the earnings yield of the instruments employed in these transactions by lowering the quality or by mismatching the maturity of the resale and repurchase agreements.

Risks inherent in repos should be controlled by policy guidelines that:

- Establish account limits.
- Require approximately matched asset and liability maturities with guidelines for acceptable levels of asset and liability mismatches.
- Provide for reasonable collateral margin and valuation techniques.
- Subject the underlying securities of a resale agreement to periodic market valuation in order to determine market exposure.
- Mandate credit approvals for parties providing securities acquired under agreements to resell.
- Insist that characteristics of the money market instruments be compatible with the branch's own investment standards.

## Other Issues for Examiner Consideration

This section contains several important issues examiners should consider when examining investment portfolios. It covers (1) transfers of low quality securities, (2) the selection of securities dealers, and (3) unsuitable investment practices.

### *Transfers of Low Quality Securities*

Low quality securities, broadly defined, include depreciated or sub-investment grade securities of questionable quality. As with other poor quality assets, the transfer of such securities from the branch to another branch or financial institution may be made to avoid detection and classification during regulatory examinations. These transfers may be accomplished through

participations, purchases/sales, and asset swaps with other affiliated or nonaffiliated entities. Examiners should be alert to situations where a branch's intention seems to be the concealment of low quality securities for the purpose of avoiding examination scrutiny and possible classification. Refer to the section on Credit Risk Management for further information. If situations are uncovered where it is determined that a transfer of securities was undertaken for legitimate reasons, the examiner should make certain that the securities have been properly recorded on the books of the acquiring branch at a reasonable or fair market value during the examination of that branch.

### *Selection of Securities Dealers*

Speculative activity often occurs when an investment portfolio manager follows the advice of securities dealers who, in order to generate commission income, encourage speculative practices that are unsuitable for the investment portfolio.

It is common for investment portfolio managers to rely on the expertise and advice of a securities sales representative for recommendations of proposed investments, investment strategies, and the timing and pricing of securities transactions. Accordingly, it is important for branch management to know the securities firms and the personnel with whom it deals. An investment manager should not engage in securities transactions with any securities dealer that is unwilling to provide complete and timely disclosure of its financial condition. Branch management must review the dealer's financial statements and make a judgment about the ability and willingness of the dealer to honor its commitments.

Head office management should review and approve, or at least closely monitor, the list of securities firms with whom local branch management is authorized to do business. The following securities dealer selection standards are recommended but are not all inclusive. The dealer selection process should include:

- A consideration of the ability of the securities dealer and its subsidiaries or affiliates to fulfill commitments as evidenced by capital strength and operating results disclosed in current financial data, annual reports, credit reports, etc.

- An inquiry into the dealer's general track record with respect to financial stability and fair and honest dealings with customers, including an inquiry of past or current customers of the securities dealer.
- An inquiry of appropriate state or federal securities regulators and securities industry self-regulatory organizations, such as the National Association of Securities Dealers, concerning any formal enforcement actions against the dealer or its affiliates or associated personnel.
- An inquiry, as appropriate, into the background of the sales representative to determine his or her experience and expertise.
- A determination of whether the branch has appropriate procedures to establish possession or control of securities purchased. Purchased securities and repurchase agreement collateral should only be kept in safekeeping with selling dealers when (1) local and head office management is completely satisfied as to the creditworthiness of the securities dealer, (2) the aggregate value of securities held in safekeeping in this manner is within credit limitations that have been approved by local and head office management for unsecured transactions and (3) at least two signatures are required for the sale/release of the security.

The process of managing relationships with securities dealers may affect the branch's code of ethics or conduct as it relates to employee activities. Specifically, the branch should consider prohibiting employees who are directly

involved in purchasing and selling securities for the branch from conducting their own personal securities transactions with the same securities firm employed by the branch unless approved and under periodic review by local and head office management. Local and head office management may also wish to adopt a policy applicable to officers or employees, concerning the receipt of gratuities or travel expenses from approved dealer firms and their personnel.

### *Objectionable Investment Practices*

Local and head office management is responsible for the prudent administration of branch investments in securities. An investment portfolio traditionally has been maintained to provide earnings, liquidity, and a means of diversifying risks. When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of prudent investment activities and should be conducted in a securities trading account. Securities trading is viewed as an unsuitable activity when conducted in a branch's investment account. Securities trading should take place only in a closely supervised trading account. Acquisitions of the various forms of zero coupon, stripped obligations, and asset backed securities residuals will receive increased regulatory attention and, depending upon the circumstances, may be considered unsuitable for a branch.

# Securities Activities

## Examination Objectives

Effective date July 1997

## Section 3130.2

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1. To determine if policies, practices, procedures, and internal controls regarding securities activities are adequate.
2. To determine if branch employees are operating in conformance with the established internal and supervisory guidelines.
3. To determine the scope and adequacy of the internal and external audit functions as it relates to this area.
4. To determine the overall quality of the investment portfolio and how that quality relates to the soundness of the branch.
5. To determine if the branch is properly accounting for its securities.
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 or regulations have been noted.

# Securities Activities

## Examination Procedures

Effective date July 1997

## Section 3130.3

1. If selected for implementation, complete or update the Internal Control Questionnaire for this section.
2. Obtain a list of deficiencies noted in the previous examination report or by internal and external auditors, and determine if management has adequately addressed the deficiencies.
3. Review the branch's investment policy and determine its adequacy. Ascertain whether the policy has been revised since the previous examination.
4. Review the reconciliation of the investment security trial balances to the general ledger.
5. Review management reports for accuracy and completeness.
6. Review policies for classifying transactions as held to maturity, available for sale, or trading.
7. Review policies for classifying investment securities for credit or transfer risk.
8. Obtain a list of securities categorized as held to maturity, available for sale, and trading including:
  - a. Descriptions of securities held (par, book, and market values).
  - b. Names of issuers.
  - c. Issuers' countries of domicile.
  - d. Interest rates.
  - e. Pledged securities.
  - f. Internal credit rating.
9. Reflecting the scope of the examination, select investments for review. If transaction volume permits, include all securities purchased since the prior examination in the population of items to be reviewed. Perform the following procedures for each investment:
  - a. For rated issues:
    - Compare the branch's internal ratings to the most recent published ratings.
    - Verify CUSIP.
    - Check prospectus.
  - b. For unrated issues:
    - Perform a credit analysis to determine if the issues can be considered speculative.
  - c. If market prices are provided to the branch by an independent party (excludes affiliates and securities dealers selling investments to the branch) or if they are independently tested as a documented part of the branch's audit program, those prices should be accepted. If the independence of the prices cannot be established, test market values by reference to one of the following sources:
    - Published quotations, if available.
    - Appraisals by outside pricing services, if performed.
    - If market prices are provided by the branch and cannot be verified by reference to published quotations or other sources, test those prices by using the comparative yield method to calculate approximate yield to maturity as follows:
      - Annual Interest
      - Par Value and Book Value
      - Number of Years to Maturity
      - Branch Provided Market Price + Par Value
  - d. Compare the branch provided market price and the examiner calculated approximate yield to maturity to an independent, publicly offered yield or market price for a similar type of investment with similar rating, trading volume, and maturity or call characteristics.
  - e. Investigate significant market value variances.
10. To the extent practical under the circumstances, perform a credit analysis of:
  - a. Selected obligors on securities purchased under agreements to resell.
  - b. All defaulted issues.
11. Classify speculative and defaulted issues according to the following standards (except those securities with transfer risk where a more severe classification may be warranted):
  - a. The entire book value of speculative grade municipal general obligation securities, which are not in default, will be classified substandard. Market depreciation on other speculative issues should be classified doubtful. The remaining book value usually is classified substandard.
  - b. The entire book value of all defaulted municipal general obligation securities will be classified doubtful. Market depreciation on other defaulted bonds should

- be classified loss. The remaining book value usually is classified substandard.
- c. Market depreciation on nonexempt stock should be classified loss.
  - d. Report comments should include:
    - Description of issue.
    - How and when each issue was acquired.
    - Default date.
    - Date interest paid to.
    - Rating at time of acquisition.
    - Comments supporting the classification.
12. With regard to potential unsafe and unsound investment practices, review the list of securities purchased and/or sold since the prior examination and:
- a. Determine if the branch engages one securities dealer or salesperson for virtually all transactions. If so:
    - Evaluate the reasonableness of the relationship on the basis of the dealer's location and creditworthiness.
    - Compare purchase and sale prices to independently established market prices as of trade dates, if appropriate.
  - b. Determine if investment account securities have been purchased from the branch's own trading department. If so:
    - Independently establish the market price, as of trade date.
    - Review trading account purchase and sale confirmations and determine if the security was transferred to the investment portfolio at market price.
    - Review controls designed to prevent gains trading.
  - c. Determine if the volume of trading activity in the investment portfolio seems unwarranted. If so:
    - Review investment account daily ledgers and transaction invoices to determine if sales were matched by a like amount of purchases.
    - Determine whether the branch is financing a dealer's inventory.
    - Compare purchase and sale prices with independently established market prices as of trade dates, if appropriate. The carrying value should be determined by the market value of the securities as of the trade date.
13. Discuss with appropriate officer(s) and prepare report comments on:
- a. Defaulted issues.
  - b. Speculative issues.
  - c. Incomplete credit information.
  - d. Absence of necessary legal opinions.
  - e. Significant changes in maturity scheduling.
  - f. Shifts in the rated quality of holdings.
  - g. Concentrations.
  - h. Unbalanced earnings and risk considerations.
  - i. Unsafe and unsound investment practices.
  - j. Apparent violations of laws, rulings, and regulations (including compliance with FAS 115).
  - k. Market value depreciation, if significant.
  - l. Weaknesses in supervision.
  - m. Policy deficiencies.
14. Update workpapers with any information that will facilitate future examinations.

# Securities Activities

## Internal Control Questionnaire

Effective date July 1997

## Section 3130.4

Review the branch's internal controls, policies, practices, and procedures regarding purchases, sales, and servicing of the investment portfolio. The branch'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. For information on trading securities, refer to the *Trading Activities Manual*.

### POLICIES

1. Has local and head office management adopted written investment securities policies that outline:
  - a. Objectives?
  - b. Permissible types of investments?
  - c. Diversification guidelines to prevent undue concentration?
  - d. Maturity schedules?
  - e. Limitations on quality ratings?
  - f. Policies regarding exceptions to standard policy?
  - g. Valuation procedures and frequency?
2. Are investment policies reviewed at least annually by local and head office management to determine if they are compatible with changing market conditions?
3. Are securities designated at time of purchase as to whether they are held-to-maturity, available-for-sale, or trading? Who is responsible for the designation?
4. Have policies been established governing the transfer of securities between the held-to-maturity, available-for-sale, and trading accounts? Who is authorized to change a security's designation?
5. Do individual officers have set investment limits?
6. Do security transactions require dual authorization?
7. Are investment securities subject to credit reviews prior to purchase, and are annual reviews performed on nonrated issues and issues with significant deterioration?
8. Are securities purchases within prescribed approval limits?
9. Are below investment grade securities included on internal watch lists and subject to the same scrutiny as problem credits?
10. Are stress tests appropriately performed for high risk securities?

### CUSTODY OF SECURITIES

11. Do procedures preclude the custodian of the branch securities from:
  - a. Having sole physical access to securities?
  - b. Preparing release documents without the approval of authorized persons?
  - c. Preparing release documents not subsequently examined or tested by a second custodian?
  - d. Performing more than one of the following transactions:
    - execution of trades,
    - receipt or delivery of securities,
    - receipt and disbursement of proceeds?
12. Are securities physically safeguarded to prevent loss or unauthorized removal or use?
13. Are securities, other than bearer securities, held only in the name or nominee of the branch?
14. Are bearer securities safeguarded appropriately?

### RECORDS

15. Do subsidiary records of investment securities show all pertinent data describing the security; its location; pledged or unpledged status; premium amortization; discount accretion; and interest earned, collected, and accrued?
16. Is the preparation and posting of subsidiary records performed or reviewed by persons who do not also have sole custody of securities?
17. Are subsidiary records reconciled, at least monthly, to the appropriate general ledger accounts and are reconciling items investigated by persons who do not also have sole custody of securities?

**PURCHASES, SALES AND REDEMPTIONS**

18. Is the preparation and posting of purchase, sale, and redemption records performed or reviewed by persons who do not also have sole custody of securities or authorization to execute trades?
19. Are supporting documents, such as brokers' confirmations and account statements for recorded purchases and sales, checked or reviewed subsequently by persons who do not also have sole custody of securities or authorization to execute trades?
20. Are purchase confirmations compared to delivered securities or safekeeping receipts

to determine if the securities delivered are the securities purchased?

**CONCLUSION**

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

# Securities Activities

## Audit Guidelines

Effective date July 1997

## Section 3130.5

1. Verify the accuracy of the investment account trial balances.
2. Test the reconciliations of the trial balances to the general ledger.
3. If investments are held in safekeeping at locations outside the branch, request the safekeeping agent to provide lists of securities held including name, description, par value, interest rate, due date, pledge status, and payment date of next coupon.
4. Using appropriate sampling techniques, select certain investments and:
  - a. For investments held at the branch:
    - Examine and count the securities.
    - Compare details of certificates to trial balances.
    - If securities are pledged to secure the branch's liabilities, determine that they are properly segregated from other securities.
    - Determine if coupons are intact.
    - Investigate any discrepancies.
  - b. For investments *not* held at the branch:
    - Compare trial balance details to safekeeping receipts and the safekeeping agent's confirmation list.
    - Determine that pledge status, if any, is properly noted on the safekeeping agent's confirmation list.
    - Investigate any discrepancies.
  - c. For investments purchased since the prior audit:
    - Verify cost by examining invoices, broker's advices, or other independent sources.
    - Determine that the securities were properly recorded in the general ledger.
    - Determine that purchases were approved by local and head office management.
  - d. For investments purchased at a premium or discount, test book value by:
    - Determining the branch's method of calculating and recording amortization of premiums and accretion of discounts.
    - Determining the gross amount of premium or discount at purchase date.
    - Determining the period to maturity or call date.
    - Calculating the amount of premium remaining to be amortized or discount remaining to be accreted.
    - Determining that book value is reflected properly in the general ledger.
    - Investigating any discrepancies.
    - Scanning previously tested amortization or accretion schedules for investments acquired before the prior audit and investigating any significant departure from these schedules.
5. Test gains and losses on disposal of investment securities since the prior audit by sampling investment sales records and:
  - a. Determining sales price by examining invoices or brokers' advices.
  - b. Checking computation of book value on settlement date.
  - c. Calculating gain or loss and tracing the amount to its proper recording in the general ledger.
  - d. Determining that the general ledger properly reflects the disposal of the investment and other related accounts.
  - e. Determining that sales were approved by local and head office management or a designated committee.
6. Test accrued interest by:
  - a. Determining the branch's method of calculating and recording interest accruals.
  - b. Determining that interest accruals are not being made on defaulted issues.
  - c. Randomly selecting certain transactions and:
    - Determining the interest rate and last interest payment date of coupons and money market instruments.
    - Calculating accrued interest and comparing it to the trial balance(s).
7. If the branch is engaged in mortgage-backed or high risk securities, evaluate the interest risk exposure associated with the various instruments by performing independent stress tests.

Funds management is an essential element of sound planning and financial management for any financial institution. A sound basis for evaluating funds management requires understanding the branch, its customer mix, the nature of its assets and liabilities, and its economic and competitive environment. No single theory can be applied universally to all branches. The purpose of funds management is to ensure adequate liquidity and effectively manage the spread between interest earned and interest paid. Therefore, funds management has two components: liquidity and interest rate risk management. This section primarily addresses liquidity. Interest rate risk management is addressed in Section 3210 of this manual, and should be read in conjunction with this section.

## LIQUIDITY

Liquidity is defined as the ability to meet asset and liability obligations without delay, including the funding of loan commitments. In a sound liquidity management system, it is essential for a branch to provide for fluctuations in its balance sheet and meet immediate or day-to-day obligations as opposed to providing funds for long-term growth.

A branch generally has both internal and external sources of liquidity. Internal sources of liquidity include short-term, high-quality assets that are readily convertible to cash at a reasonable cost. External sources of liquidity include borrowings from related offices of the foreign banking organization (FBO), other financial institutions, and overnight or short-term depositors.

The price of liquidity is a function of general market conditions and the market's perception of the FBO. Generally, the higher the risk profile of the FBO, the higher the FBO's cost of funds and the greater its need to meet liquidity demands through the management of its liabilities. Generally, the market perception of the branch can be no better than the market perception of the FBO.

## BRANCH/FBO RELATIONSHIP

Liquidity at a branch is closely integrated with

that of the FBO. While a branch, on a stand alone basis, may be able to obtain sufficient funding at a reasonable cost (by either increasing funding sources or converting assets to cash), from a market standpoint, there is no distinction between the branch and the FBO. Even if all of the branch's assets consisted of high-quality, liquid securities, liquidity would still be influenced by the market perception of the FBO as a whole.

In evaluating funds management and liquidity, the examiner should begin with an understanding of the FBO's current financial situation and be familiar with any potential liquidity concerns that could affect the branch.<sup>1</sup> Generally, if the FBO is in sound financial condition and has satisfactory market ratings, the evaluation of liquidity at the branch will be a lesser concern. In such a case, the examiner should limit the analysis of liquidity to (1) reviewing information supporting the adequacy of liquidity at the FBO, (2) developing a thorough understanding of the branch's funds management and liquidity profile, and (3) reviewing how the branch's funding and liquidity are guided and monitored, either directly or indirectly, by the head office and/or a U.S. regional office.

In contrast, if the FBO's current financial condition or market perception raises concerns regarding funds management and liquidity, the examiner should conduct a more in-depth evaluation of branch liquidity. The evaluation should consider the branch's funds management profile with close attention to: (1) funding sources; (2) liquidity and funding gaps; (3) funds management policy guidance from the head office; (4) current economic and market conditions; and (5) the adequacy of the contingency funding plan. The examiner should be prepared to make recommendations to address any identified or potential concerns at the branch and, if appropriate, at other U.S. or U.S.-managed or controlled offshore operations.

FBOs with multiple U.S. operations may centralize funds management and liquidity at a regional U.S. office. The examination of such a regional U.S. office, therefore, should include an evaluation of funds management and liquidity

1. This information is available to examiners as a part of the FBO's annual strength of support assessment. Examiners should review this assessment as a part of the pre-examination planning process, and be prepared to consider this information in evaluating the branch's funds management and liquidity.

for the branch's entire area of responsibility, including any U.S.-managed or controlled off-shore operations.

## FUNDS MANAGEMENT AND LIQUIDITY PROFILE

The examiner should understand and evaluate the branch's funding and liquidity profile. Regardless of the condition of the FBO, the branch's funding profile, or whether the branch manages its own funding needs, this review should begin with an understanding of the FBO's funds management guidelines and practices for the branch. Head office should provide branch management with funds management and liquidity guidelines and some method of daily monitoring compliance with these guidelines. Generally, the greater the complexity of the branch or its responsibilities in funds management and liquidity, the more comprehensive the guidelines and monitoring practices.

A major point to consider in evaluating branch liquidity is whether the FBO views the branch as a net user or provider of funds. The examiner should determine if the FBO has been a consistent supplier of funds, or whether the branch acts as a dollar funding vehicle for the FBO. This determination, which is particularly important if the FBO raises liquidity concerns, will be evident from the trend in the net "Due From" position with related parties. The examiner should review a period of branch quarterly Reports of Assets and Liabilities (FFIEC 002) to determine the direction, volume, and frequency of the flow of funds between the branch and its head office or other related parties, including U.S.-managed or controlled offshore operations. The examiner should take into consideration that an analysis of quarter-end reports may not provide a true picture of ongoing activities due to certain types of balance sheet window dressing activities employed by the branch. Average statements of condition should be obtained in order to get a true picture of branch liquidity over time. From a supervisory viewpoint, a net due to position is regarded more favorably than a net due from position because it provides a cushion for nonrelated depositors and creditors. However, any recommendations related to the branch's funding role should be considered in relation to the FBO's overall financial condition and other factors discussed in this section. For

additional information on funding transactions with related parties, refer to Section 3240, Due From/Due To Related Parties.

The evaluation of funds management and liquidity should also consider the branch's cost and distribution of funds; economic and market trends; levels of liquid assets; future earnings capacity; asset quality; concentrations; customer mix; the nature and mix of its assets and liabilities, including maturity, currency and repricing mismatches; and its anticipated funding needs. Generally, these considerations are more significant if the branch manages its own funding and liquidity needs.

*The remaining discussion is applicable to branches that are not simply net users of funds and have some degree of control over their funds management.*

## POLICY GUIDANCE

Branch management is expected to maintain policies and procedures approved by head office that facilitate the development of funding and liquidity strategies. Policies and procedures should provide an outline of goals regarding the FBO's asset and liability management, liquidity, off-balance-sheet exposure, degree of risk tolerance, and other relevant factors. The individual or committee responsible for funds management decisions, including monitoring anticipated funding needs, funding strategies, guidelines and limitations, should be specified in the policies and procedures. The depth of these policies and procedures will depend upon the degree to which branch management is responsible for funds management. In some cases, the head office or U.S. regional management is largely responsible for funds management at the branch. In other cases, responsibility rests with local branch management.

Policy statements should address limitations on funding sources to avoid a concentration to any one source or grouping. They also should identify alternative funding sources, the degree of support dictated by the FBO, and the nature of that support. Interest rate sensitivity matching, maturity matching, and the use of financial derivatives may be addressed under these policies or in a separate interest rate risk policy. Written procedures should provide staff with a reference document on the day-to-day procedures

in funding and provide for a system of internal control in critical areas, such as separation of duties, proper completion of reports, and monitoring of limits. Refer to Interest Rate Risk Management, Section 3210 for additional information on policies and procedures.

## MANAGEMENT INFORMATION SYSTEMS

An effective Management Information System (MIS) is integral to making sound funds management and liquidity decisions and is a factor in evaluating the branch's financial controls. Reports containing certain basic information should be prepared and reviewed regularly by management. Report content and format will vary among branches; however, an effective MIS will contain reports detailing liquidity needs and the sources of funds available to meet those needs. Typically MIS may include the following: the maturity distribution of assets and liabilities, and the related gaps, including maximum and minimum liquidity needs; expected funding of commitments; asset yields; liability costs; net interest margins and variances (both from prior months and budget); funding volumes by liability, customer, market, and overnight/short-term funds; and exceptions to policy guidelines and limits. Refer to Section 3410, Management Information Systems, for additional information.

## FUNDING AND LIQUIDITY PRACTICES

A branch responsible for its own funding and liquidity needs may meet those needs by manipulating its asset structure through the sale or planned runoff of short-term or readily marketable assets. As an alternative, the branch could transfer to the head office or other related offices, a block of assets that would serve to reduce its asset base and increase liquidity. As a matter of general practice, however, a branch can meet its liquidity needs by manipulating its liability structure to access discretionary funding sources or derive funds from its intercompany funding base. The ability of a branch to access discretionary funding sources is ultimately a function of the position of the FBO in the money markets. An FBO with strong

creditworthiness affords its branches easier access to funds at market rates.

The ability to obtain additional funding sources represents liquidity potential. The marginal cost of liquidity or the cost of incremental funds acquired is of paramount importance in evaluating liability sources of liquidity. Consideration must be given to factors such as how frequently the branch must regularly refinance maturing liabilities and an evaluation of the branch's ongoing ability to obtain funds under normal market conditions. The obvious difficulty in estimating the latter is that until the branch goes to the market to borrow, it cannot determine with complete certainty that funds will be available at a price that will maintain a positive yield spread. Changes in money market conditions or the FBO's financial strength may cause a rapid deterioration in a branch's capacity to borrow at a favorable rate. In this context, liquidity potential represents the ability to attract funds in the market, when needed, at reasonable cost compared to asset yield.

Frequently, the base rate for funding costs on money market transactions is available only to the largest and most financially sound institutions. Some branches may pay in excess of the base rate for money market funds, with the differential denoting the market's perception of the FBO and home country conditions. The size of the premium compared to other FBOs can be a rough indication of the stability of funding sources in this market. As indicated earlier, if the FBO carries a rating of AAA or AA by an independent rating agency, it is unlikely that funding and liquidity will be an examination issue. If the FBO carries a lower rating or has no market presence, the probability that there may be funding and liquidity concerns grows proportionately and funds management and liquidity are more critical.

## FUNDING AVAILABILITY

Management at the branch and head office must be constantly aware of the composition, characteristics, and diversification of its funding sources. If possible, the branch should secure funding lines from multiple sources. In certain instances, the branch may be using suballocated lines from its head office. With multiple source advised discretionary lines of credit, the branch is much better positioned to manage usage and

rotation in order to ensure availability of funds at competitive pricing. The role of the FBO in this circumstance would be to provide backup resources and to be the ultimate lender for contingency purposes.

Nevertheless, many interbank credit agreements contain escape provisions, known as material adverse change clauses, that enable the lending bank to refuse to allow the borrowing bank to draw on advised credit lines. Banking organizations experiencing considerable problems, particularly those relating to asset quality and/or liquidity, have found that these facilities are no longer available. Such escape provisions should be considered in the assessment of funds management and liquidity.

## CONTINGENCY FUNDING

Examiners should determine if management at the branch has an effective contingency plan that identifies minimum and maximum liquidity needs both in normal and adverse market conditions, and weighs alternative courses of action to meet these needs. The branch may rely on back-up funding lines or support from the head office or other related offices to meet unforeseen liquidity demands. In this case, examiners should comment on the FBO's ability to meet these needs.

## HOME COUNTRY FUNDING RESTRICTIONS

An FBO's home country may impose restrictions on capital outflows. Such impediments could defeat the attempts of the FBO to aid the

branch in the event of a liquidity crisis. For this reason, the examiner should investigate home country funding restrictions.

## TRANSFER RISK CONSIDERATIONS

The stability and availability of funding should be related to the distribution of assets, taking into consideration certain assets subject to transfer risk. Potential liquidity problems may exist when a branch relies heavily on the U.S. money market for funding, while its assets are concentrated in a country with serious economic problems. In such a case, the branch is typically in a net due from position with the FBO and problems may arise if the FBO or borrowers do not have ready access to U.S. dollars to meet their obligations. Refer to Section 6020, Transfer Risk, for additional information.

## OFF-BALANCE-SHEET CONSIDERATIONS

The nature, volume and anticipated usage of off-balance-sheet activity must be factored into the assessment of funds management and liquidity. The potential for funding contingent liabilities varies widely, but the most likely to require funding are loan commitments. Economic conditions and the business cycle may also influence anticipated usage. The branch should have sufficient existing funding sources to provide for anticipated usage, in view of the nature and volume of its contingent liabilities.

# Funds Management and Liquidity

## Examination Objectives

Effective date July 1997

## Section 3200.2

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1. To assess the branch's ability to obtain stable funding sources from related and unrelated parties.
2. To determine if reasonable local policies, procedures, and parameters have been established and approved by the head office for the branch's liquidity position and if the branch is operating within those established guidelines.
3. To evaluate the management of assets, liabilities, and off-balance-sheet positions to determine if management is planning adequately for liquidity and if the branch can effectively meet anticipated and potential liquidity needs.
4. To determine if internal management reports provide the necessary information for informed liquidity decisions and monitoring their results, and that reports are regularly provided and reviewed by head office.
5. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Funds Management and Liquidity Examination Procedures

Effective date July 1997

## Section 3200.3

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1. Evaluate the funding relationship between the branch and the FBO. Consider the reasons why the branch is in a net due from or due to position with related offices and affiliates of the FBO.
2. Review the Funds Management and Liquidity policies, practices, and procedures and test for compliance. Ensure that there are:
  - a. Lines of authority and responsibility for liquidity management decisions.
  - b. Formal mechanisms to coordinate funds management and liability decisions.
  - c. Methods to identify liquidity needs and the means to meet those needs.
  - d. Guidelines for the level of liquid assets and funding sources in relation to anticipated and potential needs.
  - e. Appropriate controls and supervision of the volume of loan commitments and other off-balance sheet exposure that may impact funding and liquidity.
3. Determine if management has planned properly for liquidity and if the branch has adequate sources of funds to meet anticipated or potential needs by:
  - a. Reviewing the internal management reports detailing liquidity requirements and sources of liquidity.
  - b. Evaluating primary and secondary sources of funds.
  - c. Determining whether funding and liquidity requirements are factored into the budgeting process and are based on growth projections, changes in the branch's asset and liability mix, and other anticipated changes.
4. Evaluate the effectiveness of the internal management reporting system in providing for adequate liquidity management.
5. Discuss the following issues with management and summarize findings in the workpapers and, to the degree necessary, for the examination report:
  - a. The quality of the branch's planning and the current ability of the branch to meet anticipated and potential liquidity needs.
  - b. The quality of administrative control and internal management reporting systems.
6. Update the workpapers with any information that will facilitate future examinations. Discuss with senior branch management the findings of the examination regarding the branch's funding and liquidity policies and practices, and document the discussion in the workpapers.

# Funds Management and Liquidity Internal Control Questionnaire

Effective date July 1997

## Section 3200.4

1. Is the FBO in less than satisfactory condition and subject to liquidity concerns?
2. Is the FBO subject to market disciplinary pricing?
3. Does the FBO's home country impose restrictions on capital outflows?
4. Has the branch and head office management, consistent with its duties and responsibilities, adopted funds management policies, practices and procedures which include:
  - a. Lines of authority, and responsibility for funds management and liquidity decisions?
  - b. A formal mechanism to coordinate funds management and liquidity decisions?
  - c. A method to identify funding and liquidity needs and the means to meet those needs?
  - d. A contingency funding plan that provides guidelines for the level of liquid assets and other sources of funds in relationship to anticipated and potential needs?
  - e. An adequate system of internal controls in critical areas, such as separation of duties, proper MIS reporting and monitoring of limits?
  - f. Transfer risk considerations?
5. Does the FBO view the branch as net user or provider of funds?

If the branch is a net user of funds:

  - a. Does the branch have a funding and liquidity profile that identifies the branch as a non-risk taker?
  - b. Are funds management and liquidity decisions centralized at an FBO location within the U.S. that is subject to regulatory supervision?

*If the branch is a net provider of funds, answer the following questions; otherwise proceed to question 12.*
6. Have internal management reports been prepared that provide an adequate basis for making ongoing liquidity management decisions and for monitoring the results of those decisions?
7. Do management reports include the following:
  - a. Maturity distribution of assets and liabilities?
  - b. Expected funding commitments?
  - c. Asset yields and liability costs?
  - d. Net interest margin and variance analysis (e.g., previous month, quarter, year-to-date and budget reporting)?
  - e. Funding volumes by type of liability (e.g., overnight/short-term funds), customer and market?
  - f. Exceptions to policy guidelines and limits?
8. Does the planning and budgeting function consider funding and liquidity requirements?
9. Does the branch's contingency funding plan address:
  - a. Minimum and maximum liquidity needs and alternative courses of action to meet those needs?
  - b. Alternative sources of funding?
  - c. Orderly asset liquidation?
10. Have adequate discretionary (back-up) lines of credit been established?
11. Are advised discretionary lines of credit containing adverse change clauses considered by branch management in its contingency funding plan?
12. Is the information covered by this ICQ adequate for evaluating internal controls in this area? If not, indicate any additional examination procedures deemed necessary.
13. Based on the information gathered, evaluate the internal controls in this area (i.e., strong, satisfactory, fair, marginal, unsatisfactory).

Interest rate risk (IRR) is an aspect of normal banking operations that became increasingly important in the United States with the deregulation of interest rates in the early 1980s. The phaseout of interest rate controls and increased competitiveness, the latter of which was partly due to the growing presence of foreign banks in U.S. markets, significantly increased the flexibility of banks in adjusting their IRR profiles. This flexibility has been further enhanced by the development of new financial instruments used to hedge against or profit from interest rate changes.

In order to maintain profitability, safety, and soundness, institutions should fully comprehend the risks associated with changes in interest rates and should have adequate policies and systems in place for controlling these risks. In this regard, the branch and its head office management both have important responsibilities.

The head office is responsible for providing clear policy guidance to branch management on controlling and monitoring IRR. The policies provided to branch management by the head office should indicate acceptable levels of risk-taking, given the branch's role in the foreign banking organization (FBO), and establish procedures and controls to ensure that there is an adequate system for measuring IRR and monitoring compliance with established limits. In this regard, there should also be a reporting process that demonstrates adherence with established limits and an adequate system of internal controls.

It is recognized that, as part of a larger entity, IRR management for certain branches may be centralized within the FBO. Whether or not the branch is responsible for managing its IRR, there should be evidence at the branch, in the form of IRR policy guidelines, management reports, etc., showing how this risk is being effectively identified, measured, and controlled for the branch. *The following discussion provides an overview of IRR considerations, which the examiner should use in reviewing, to the extent applicable, this area of risk within the branch.*

### INTEREST RATE RISK

IRR is defined as a branch's vulnerability to changes in interest rates. IRR arises from differ-

ences in the maturities or repricing dates of asset and liability positions, and cash flows. However, risk may remain in a given branch's portfolio in which long and short positions of different maturities are well hedged against a uniform change in all interest rates, but not against a change in the shape of the yield curve where interest rates of different maturities change by varying amounts. This type of risk is called "yield-curve risk." Similarly, a branch may be well hedged against yield curve risk but exposed to "basis risk," in which the prices of particular assets and liabilities, as well as hedging instruments, are not perfectly correlated. For example, three-month interbank deposits priced at LIBOR, three-month Eurodollars and three-month Treasury bills all pay three-month interest rates. However, these three-month rates are not perfectly correlated with each other and spreads between their yields may vary over time. As a result, three-month Treasury bills, for example, funded by three-month interbank deposits are not a perfectly hedged position. Given a rise or decline in interest rates, a branch's interest rate exposure can be viewed as the potential for change in its reported earnings.

Focusing on the sensitivity of a branch's reported earnings to changes in interest rates represents an accounting perspective of IRR assessment. In general, this approach involves assessing the effect that changing rates might have on the revenues produced by interest-earning assets, the expense of interest-bearing liabilities, and the resulting net interest income of the branch. Risk to current earnings measures the timing of income effects, which can help risk managers determine what action to take regarding exposure.

### RISK MEASUREMENT TECHNIQUES

Branches can use a variety of methods to measure their IRR exposure. The three most common generic methods are maturity gap analysis (used to measure the interest rate sensitivity of earnings), duration analysis, and simulation modeling. While these methods highlight different facets of IRR, many branches use them in combination or use hybrid methods that combine features of each.

## Maturity Gap Analysis

Maturity gap analysis begins with constructing a maturity gap report. This report categorizes asset and liability accounts, including off-balance-sheet items, according to the time remaining to their maturities in specific time periods, known as repricing buckets. These buckets vary from branch to branch, but most branches include time bands of overnight, overnight to one month, one month to three months, three months to six months, six months to one year, and beyond one year. Categorizing assets and liabilities lacking definitive repricing time frames into specific time periods (or buckets) varies by institution. As a result, the assumptions used by each institution should be reviewed by the examiner to ensure that they are reasonable. This approach reflects the accounting or current earnings orientation of gap reports.

For each time period or bucket, rate-sensitive liabilities (RSL) are subtracted from rate-sensitive assets (RSA) to yield the dollar maturity mismatch or gap. The gap measure is either a positive or negative dollar amount and is the primary tool used to assess the impact of changes in interest rates on the institution's net interest income.

A negative gap (liability sensitive) indicates that more liabilities than assets will reprice in a given time period. During periods of rising interest rates, net interest income would be adversely affected because the interest expense on liabilities during that period would show a greater increase relative to the increase in interest earnings on assets. If rates decline, a bank with a negative gap would expect its earnings to be enhanced because more liabilities than assets would reprice at lower rates.

Conversely, a positive gap (asset sensitive) indicates that more assets than liabilities will reprice in a given time period. In this case, earnings tend to increase as interest rates increase because more assets than liabilities reprice at higher rates.

The maturity gap of an institution is the most basic measure of IRR. It is a static measure that assumes the current balance sheet remains constant through time and a given change in interest rates is not reversed over time. For this reason, it may not accurately reflect a branch's true risk exposure. In addition, its emphasis on the risk to short-term earnings inadequately addresses the rate sensitivity of longer-term fixed rate instru-

ments, the value of which can change dramatically without affecting short-term interest income.

Some simple forms of maturity gap analysis identify only the amount of assets and liabilities at risk and ignore basis risk. Basis risk refers to the likelihood that changes in interest rates a branch pays on liabilities and earns on its assets are not perfectly correlated. That risk is present, even when the assets and liabilities are matched in terms of their maturity or repricing periods. Despite these shortcomings, most branches use maturity gap analysis or some variant, as one component of IRR measurement. Many branches elaborate on the simple gap framework in order to gain insight into the more complex aspects of IRR.

While the maturity gap of an institution is a widely used indicator of IRR, it is not a sufficient measure for gauging overall exposure when taken alone. A branch's condition and size, complexity of the balance-sheet and off-balance-sheet activities (if any), degree of competition, and sophistication of the markets being served also must be considered. For example, a small, retail-oriented branch may have moderately large negative gap positions but may not be exposed to major risks. Factors that may minimize such risks are the branch's strong core deposit base within its target market.

## Duration Analysis

Duration analysis is used to calculate the weighted average maturity of the cash flows emanating from financial instruments. In contrast to the simple average nominal cash flows, duration provides more meaningful, analytical measures of a stream of cash flows. The duration measure can be used to calculate the percentage change in the present value of a stream of cash flows that is generated by a one percentage point change in interest rates. Duration analysis can measure the exposure of a branch's current income to changes in interest rates.

Duration analysis can complement gap analysis. Using gap repricing data and selected rate data, duration provides a more accurate measure of IRR. Duration analysis, unlike gap analysis, accounts for the time value of money by calculating the present value of future cash flows. In so doing, it properly aggregates the branch's repricing mismatches or gaps. Thus, duration can be used to analyze the risk standing of a

branch with a complicated series of repricing mismatches. Like gap analysis, duration analysis generally assumes that the repricing structure of a branch's assets and liabilities remains constant. In addition, duration analysis requires information on cash flows that may not always be available.

Used in conjunction with maturity gap analysis, duration analysis can add significant insights into the IRR exposure of an institution. However, duration also has some limitations, in particular:

- The duration measure becomes less accurate as the amount of the interest rate change increases;
- The duration of different instruments will change at different rates as time passes, resulting in a hedged position becoming unhedged over time; and,
- Duration alone does not address the dispersion of cash flows in a branch's portfolio.

## Simulation Modeling

Simulation techniques attempt to overcome the limitations of both the static gap and duration measures by computer-modeling the branch's interest rate sensitivity. Such modeling involves making assumptions about the future course of interest rates and changes in a branch's business activity and estimating their effect on the branch's net interest income. Branches can develop their own simulation packages or choose from a variety of commercially available packages.

A simulation model can provide branch management with an important tool for understanding the measurement of, and assisting in the management of, IRR, and for evaluating the branch's exposure under a variety of interest rate scenarios. Simulation techniques can also play an integral planning role in evaluating the effect of alternative business strategies on risk exposure. Unlike other methods, simulation can anticipate the effect of changes in customer behavior induced by interest rate changes (such as time deposit rollovers, in retail branches).

The usefulness of simulation techniques depends on the validity of the underlying assumptions and the accuracy of the basic structure upon which the model is run. If these assumptions do not fairly reflect the branch's

internal and external environment, the results obtained will not be meaningful.

## ASSESSMENT OF IRR MANAGEMENT

Examiners should focus on the presence of clear and comprehensive policies with corresponding appropriate internal controls when assessing the management of IRR. The policies should outline the following: the objectives of risk management, clear lines of authority and communication, and limits on the vulnerability of net interest income to changes in interest rates. Risk management systems and procedures should be adequate and consistent with the stated policies of risk management.

Strong internal management controls need to be maintained given the potential impact of interest rate exposure on a branch's earnings. These controls include policies, risk measurement systems, and reporting mechanisms. Each of these should be reviewed from two perspectives:

- Does management understand and effectively administer IRR controls?
- Do these controls establish reasonable parameters considering the specific IRR profile of the branch?

In larger branches, IRR may be managed by an Asset/Liability Management Committee (ALCO), which is composed of senior branch managers who represent units that undertake IRR. ALCO is responsible for formulating and administering branch strategy with regard to IRR, which is based on management's view of the future interest rate environment, the branch's relative ability to adjust to changing market conditions, and the head office's risk-acceptance level. The activities of ALCO, including the implementation of IRR policies, should be reviewed for approval by the head office.

Additionally, in the cases where IRR management is centralized at a particular branch of the FBO, the following question must be considered: Is the process of transferring a given branch's IRR to the portfolio of the branch housing the centralized IRR management function adequately governed by appropriate policies and accurate reporting mechanisms?

## POLICIES

The need for established and properly supervised IRR policies has increased greatly in recent years. An adequate policy facilitates the development of a prospective plan that considers the branch's goals regarding its asset and liability mix, off-balance-sheet activities, liquidity, risk tolerance, and other relevant factors. The policy should establish responsibility for IRR management decisions and provide a mechanism for the necessary coordination among different departments of the branch, or between different branches of the FBO, as appropriate.

In addition to establishing responsibility for planning and day-to-day IRR decisions, the policy should set forth certain guidelines:

- Interest rate exposure limits should be established relative to reasonable forecasts and assumptions;
- Limits should be based on the potential impact of interest rate changes on the branch's net interest income;
- Individual limits should be set for units that incur IRR;
- Clear lines of authority and communication should be established for the implementation and execution of strategies; and,
- For those branches that are not authorized to incur or manage IRR, the policy should clearly outline procedures for accurately and effectively transferring the IRR incurred by its normal business activities to a designated branch or other office of the FBO responsible for the centralized management of IRR.

In most cases branches accomplish the transfer of IRR incurred by a given transaction by entering into an offsetting, "mirror" transaction with the office responsible for managing the branch's IRR. As an example, if a branch entered into a five-year, fixed-rate loan, it could book a five-year, fixed-rate liability to the related office to fund the loan; the maturity and principal amount should be matched.

## RISK MANAGEMENT SYSTEMS

The effectiveness of assessing IRR through the use of a risk management system depends to a large degree on the branch's ability to measure its exposure. Risk management systems are based on a quantitative assessment of exposure

(as previously discussed) and management's adaptation and analysis of that assessment. These systems should be:

- Consistent with established limits;
- Comprehensive, covering the rate risk associated with all asset, liability, and off-balance sheet accounts;
- Capable of identifying excessive exposure;
- Capable of measuring the impact of rate changes on the branch's chosen target account(s);
- Flexible, so that the introduction of new instruments and changes in strategy can be absorbed and accounted for; and,
- Able to suggest strategies for corrective action.

## REPORTING MECHANISMS

Strong lines of communication and authority are essential to the timely execution and adjustment of a branch's IRR strategy because earnings can be rapidly eroded by unexpected rate changes. In particular, when risk management responsibilities are delegated to those most familiar with particular products or markets, the need for communication becomes stronger, so that positions in one market are not excessively magnified by positions elsewhere.

Coordination between the branch and head office management and business units that incur IRR is essential to the successful control of IRR. This is especially important when the business unit incurring IRR is another branch of the FBO. Controls should focus on the following:

- Branch and head office management should be regularly apprised of the nature and results of risk management decisions undertaken by the branch;
- Branch and head office management should be provided with periodic status reports detailing risk exposure;
- Treasury management should have periodic contact with branch line managers responsible for undertaking risk;
- Risk-taking units should be aware of limits established by head office and/or branch management, with limit exceptions regularly monitored and communicated to senior management; and,
- Units not allocated risk limits should provide the branch responsible for its IRR management

with reports detailing not only the unit's current positions, but potential or planned transactions, as well.

## PRICING

Conclusions drawn from the analysis of the branch's interest rate sensitivity position rest upon the assumption that the branch has an adequate asset-pricing mechanism. A pricing mechanism that is not attuned to the branch's cost of funds, overhead costs, and credit risk will not allow the branch to maintain an adequate net interest margin on an ongoing basis. Thus, the examiner should bear in mind the interdependence of pricing methods and interest rate sensitivity when assessing the branch's ability to maximize and maintain the spread between interest earned and interest paid.

An important component of pricing is the cost of funds. Bankers generally price from either the average cost of funds or the marginal cost of funds. The average cost of funds is a weighted average of all of the rates paid on interest-bearing liabilities. The marginal cost of funds is defined as the cost of the additional funds needed to support asset growth and is considered by many bankers to be the more economically appropriate method. This view is taken because funds on the balance sheet already support assets held and the cost of those funds should not enter into the pricing decision for new assets.

The marginal cost of funds is not, however, always the best method of pricing because the branch may be replacing assets, instead of growing. If the branch is only changing its asset mix to compensate the organization for its credit risk, its average cost of funds, plus overhead and repricing considerations, represent a more appropriate pricing measure. Additionally, market forces, which include the demand for and availability of funds, should be considered as complements to cost factors when making pricing decisions. The market in which the branch operates often dictates the pricing mechanism used.

Branches most often obtain funds from the domestic interbank money market; however, offshore sources, including related branches and the head office, are frequently used. In many

cases, a FBO may have to pay an additional spread over interbank rates for perceived country risk, liquidity risk, or credit risk. For branches required to pay such additional spreads, the size and volatility of these premiums should be considered in the institution's pricing mechanism.

## HEDGING

The examiner should keep in mind that risk may be reduced by hedging activities when determining the extent of IRR exposure at the branch. These activities may be explicit and easily quantifiable or they may be implicit and difficult to measure from the branch's management information system.

Types of explicit hedging activities include instruments such as futures, interest rate swaps, forwards, options, and various hybrid products. Types of implicit hedging might include interest rate caps and floors on commercial loans; limits on the amount of rate adjustment allowed for products, such as adjustable rate mortgages; or even investment policies that might set internal stop loss limits on various longer-term portfolio positions. Explicit hedging strategies can either be matched to a specific asset or liability ("micro" hedges) or be designed to reduce the overall level of risk in a position ("macro" or "portfolio" hedging).

Institutions engaged in hedging activities should have clearly defined policies that outline specific hedge strategies and explain how those strategies reduce risk. Individuals responsible for hedging activity should be designated and overall position limits should be established. Internal controls should be established to include a system that measures the degree to which a hedge is meeting its stated objective of reducing risk (hedge effectiveness). Finally, branch management should regularly provide reports to the head office that, at a minimum, show gains or losses on hedge instruments and estimates of hedge effectiveness.

Finally, some entities now use derivative instruments in managing IRR. The individual regulatory agencies have issued policy statements regarding derivative instruments. The examiner should consult with his/her respective agency for guidance.

# Interest Rate Risk Management

## Examination Objectives

Effective date July 1997

## Section 3210.2

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1. To evaluate the policies regarding interest rate risk (IRR) formulated by branch and head office management, including the limits established for the branch's IRR profile.
2. To determine if the branch's IRR profile is within those limits.
3. To evaluate the management of the branch's IRR, including the adequacy of the methods and assumptions used to measure IRR.
4. To determine if internal management reporting systems provide the information necessary for informed interest rate management decisions.
5. To recommend corrective action when interest rate management policies, practices, procedures, or internal controls are deficient in controlling and monitoring IRR.

# Interest Rate Risk Management Examination Procedures

Effective date July 1997

## Section 3210.3

1. Determine if there were concerns in the previous examination report regarding IRR, and if corrective action was required.
2. Determine if IRR is managed at the branch level or at another level within the FBO.
  - a. If IRR is managed at the branch level, proceed to procedure #3.
  - b. If IRR is managed at a higher level within the FBO:
    - Determine if adequate procedures are in place for any activities at the branch which are required by the managing level within the FBO (i.e. personnel authorized and steps necessary for calling in funding requirements).
    - Provide a description of the activities conducted by the managing level within the FBO.
    - Proceed to procedure #10.
3. Review the branch's written policies and procedures for reasonableness. At a minimum, policies should cover:
  - a. Definition and measurement of acceptable risks, including acceptable levels of interest rate exposure.
  - b. Net interest margin goals.
  - c. Sources and uses of funds.
  - d. Off-balance-sheet activities that affect interest rate exposure.
  - e. Responsibilities within the branch for IRR management activities.
  - f. Reporting mechanisms.
4. Evaluate the internal controls and/or the internal audit function. Determine whether internal mechanisms are adequate to ensure compliance with established limits on IRR. Prepare a brief description of the branch's internal controls/audit for IRR management and identify areas in need of improvement.
5. Evaluate management practices. The evaluation should include, but not be limited to, the following:
  - a. Determine who is responsible for making IRR management decisions (individual, committee or other), and whether this is appropriate, given the level of experience and sophistication of the individuals and the nature of the branch's activities.
  - b. Determine who is responsible for making principal assumptions and parameters used in the measurement system(s), and whether this individual or committee reviews the principal assumptions and parameters on a regular basis and updates them as needed.
  - c. Determine who is responsible for implementing strategic decisions. Ensure that the scope of that individual's authority is reasonable. Determine if any one individual exerts undue influence over the economic forecasts and management decisions.
  - d. Assess branch management's knowledge of IRR in relation to the size and complexity of the branch. In particular, assess management's understanding of the methods used by the branch to measure the risk.
  - e. Determine if new products or hedging instruments are adequately analyzed before purchase.
6. Assess senior management (i.e. lead U.S. office for FBO or head office) oversight of IRR management. The assessment should include the following:
  - a. Determine how frequently the policy is reviewed and approved by senior management (at least annually).
  - b. Determine whether the results of the measurement system provide clear and reliable information and whether the results are communicated to senior management at least quarterly. Reports to senior management should identify the branch's current position and relationship to policy limits.
  - c. Determine the extent to which exceptions to policies and resulting corrective measures are reported to senior management, including the promptness of such reporting.
7. Evaluate the risk measurement system(s) used by the branch, which should be consistent with the size and complexity of its on- and off-balance-sheet activities. The evaluation should include the following:
  - a. Evaluate whether the risk measurement system's structure and capabilities are adequate to accurately assess the risk exposure of the branch, support the institution's risk management process,

- and serve as a basis for internal limits and authorizations.
- b. Evaluate whether the risk measurement system is operated with sufficient discipline to accurately assess the risk exposure of the branch, support the institution's risk management process, and serve as a basis for internal limits and authorizations.
  - c. Determine whether the assumptions are reasonable given current business conditions and the institution's strategic plan, and whether assumptions about future business are sensitive to changes in interest rates.
8. Evaluate the branch's exposure to IRR by:
    - a. Reviewing reports regularly prepared by management for controlling and monitoring IRR.
    - b. Reviewing "variance reports," i.e., reports that compare predicted and actual results. Comment on whether the risk measurement system has made reasonably accurate predictions in earlier periods.
    - c. Determining whether the level of risk is within the limits management has set.
    - d. Determining the stability of interest margins under varying economic conditions or simulations (causes of significant fluctuations should be identified).
    - e. Determining the branch's ability to adjust its interest rate exposure, or its ability to effectively transfer its interest rate exposure to the designated unit of the FBO for IRR management.
  9. Contact the examiner responsible for analyzing income and expense to determine the adequacy of the net interest margin, based on an analysis of the components of the margin (i.e., interest expense and interest income). If the margin or any component is unusually high or low, determine:
    - a. If goals have been established for net interest earnings.
    - b. Management's success in meeting established goals.
    - c. The effect of the branch's IRR position on meeting established goals.
    - d. The effect of the branch's pricing policies on meeting established goals.
    - e. The effect of any premium charged the branch on borrowed funds resulting from any perceived liquidity risk, country risk, or credit risk on meeting established goals.
    - f. The effect of the branch's credit risk appetite on the margin.
    - g. The effect of interoffice pricing policies for borrowed funds from related offices, and the reliance on these funds, on the margin.
  10. Write in appropriate report format and discuss with management:
    - a. The quality of management's ability to control and monitor IRR.
    - b. The level of the branch's IRR exposure and an assessment of the associated degree of risk.
    - c. The quality of the related administrative controls and internal management reporting systems.
    - d. The effect of IRR management decisions on earnings.
  11. Update the workpapers with any information that will facilitate future examinations.

# Interest Rate Risk Management Internal Control Questionnaire

Effective date July 1997

Section 3210.4

Complete the following questions only if IRR is managed at the local level. If IRR is managed at another level within the FBO, determine that adequate procedures are in place for any activity required of the branch by the managing office.

1. Has branch and head office management adopted an IRR management policy that includes:
  - a. Risk management philosophy and objectives regarding IRR?
  - b. Clear lines of responsibility to either manage IRR or transfer the branch's IRR positions to the appropriate unit of the FBO assigned the IRR management function?
  - c. Defining and setting of limits on IRR exposure?
  - d. Specific procedures for reporting and approvals necessary for exceptions to policies and limits?
  - e. Plans or procedures management will implement if IRR falls outside established limits?
  - f. Specific IRR measurement system(s)?
  - g. Acceptable activities used to manage or adjust the institution's IRR exposure, including, when applicable, procedures for the transfer of IRR to the unit assigned the IRR management function?
  - h. The individuals or committees who are responsible for IRR management decisions?
  - i. A process for evaluating major new products and their IRR characteristics?
2. Have internal management reports been prepared that provide an adequate basis for making interest rate management decisions and for monitoring the results of those decisions? Specifically:
  - a. Are reports prepared on the branch's IRR exposure, using an appropriate measurement method?
  - b. Is historical information on asset yields, cost of funds, and net interest margins readily available?
  - c. Are interest margin variations, both from the prior reporting period and from the budget, regularly monitored?
  - d. Is sufficient information available to permit an analysis of the cause of interest margin variations?
3. Is the bank in compliance with its policies, and is it adhering to its written procedures? If not, are exceptions and deviations:
  - a. Approved by appropriate authorities?
  - b. Made infrequently?
  - c. Nonetheless consistent with safe and sound banking practices?
4. Does senior management review and approve the policy at least annually?
5. Did senior management review positions, and the relationship of these positions to established limits, at least quarterly?
6. Were exceptions to policies promptly reported to the senior management?
7. Does one individual exert undue influence over interest risk management activities?
8. Discuss with senior management the branch's internal risk measurement model(s) regard to the following:
  - a. Has (Have) internal model(s) been audited (by internal or external auditors)?
  - b. Does one individual control the modeling process, or otherwise exert undue influence over the risk measurement process?
  - c. Is the model reconciled to source data to assure data integrity?
  - d. Are principal assumptions and parameters used in the model reviewed periodically by senior management?
  - e. Are the workings of, and the assumptions used in, the internal model adequately documented and available for examiner review?
  - f. Is the model run on the same scenario(s) for which the institution's limits are established?
  - g. Does management compare the historical results of the model to actual results?

## CONCLUSION

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

Borrowed funds include all nondeposit liabilities, exclusive of long-term subordinated debt, such as capital notes and debentures. Common forms of direct borrowing include Federal funds purchased (overnight and term), bills payable to the Federal Reserve, interbank deposits (domestic or foreign), due bills, short sales from trading securities, and overdrafts on deposit accounts due from other depository institutions. Indirect forms of borrowing include rediscounted customer paper, trade bills and bankers acceptances, securities borrowed, and assets sold with the endorsement or guarantee of the FBO or subject to a repurchase agreement. If an FBO issues commercial paper in the U.S., the issuance is generally through a U.S. subsidiary and reflected on the books of the branch as a balance due to related institutions.

When a branch manages its borrowed funds position independently from other FBO offices, a complete analysis of its borrowing activities since the previous examination should be done. The principal sources of borrowings, the range of amounts, frequency, length of time indebted, concentration of borrowings, and reasons advanced by management for such borrowings should be explored. Some of the more frequently used sources and instruments that provide short-term, nondeposit funds are discussed below.

### INTRACOMPANY/INTERCOMPANY BORROWING

A principal borrowing relationship frequently exists between a branch and its head office. The branch may also have borrowing relationships with other related branches or affiliated companies. The head office frequently serves as a primary funding source for the branch, but the level and nature of borrowing may be determined by other factors, including the branch's role in the overall funding strategy of the FBO. For example, an FBO will designate one U.S. branch (generally the branch located in the FBO's home state) to provide the funding to all other U.S. branches. To develop a complete understanding of the borrowing relationship of the branch with the head office and other related offices, the examiner must gain an understanding of the funding strategy of the FBO in the

U.S., and should determine the purpose of the borrowing and the reason for the level and flow of funds to various offices.

For FBOs with a controlling interest in a U.S. commercial bank, a borrowing relationship between the commercial bank and offices of the FBO must be explored fully to ensure there are no violations of Sections 23A and 23B of the Federal Reserve Act, inasmuch as the FBO is considered a foreign bank holding company. Additional information on intercompany borrowing and funding relationships is contained in Section 3240, Due From/Due To Related Offices.

### FEDERAL FUNDS PURCHASED

The day-to-day use of Federal funds is commonplace among U.S. banking organizations, including branches of FBOs. The most frequent type of Federal funds transaction is unsecured, for one day, and repayable the following business day. The rate is usually determined by overall money market rates and by the available supply of and the demand for funds. Most transactions are in units of \$1 million, although the trading of smaller amounts is fairly common depending upon individual situations. In some instances, where the selling and buying relationship between two financial institutions is a more or less continuing one, a line of credit may be established on a funds-available basis. Although the most common transaction is on an "overnight" unsecured basis, the selling of funds can also be on a secured basis and for longer periods of time such as term Federal funds. While term Federal funds are quite common, the selling of funds on a secured basis is quite rare. Secured borrowing is usually done in instances of severe credit risk and/or perceived default. However, according to the Federal Reserve Act, Section 23A(c)(1), if an FBO owns a domestic, FDIC-insured subsidiary bank, any extensions of credit by the domestic bank to the FBO must be done on a secured basis.

### INTERBANK DEPOSITS AND BORROWINGS

Interbank deposits are not defined as borrowings for regulatory purposes, and continue to be

reflected as deposits. Interbank deposit instruments include certificates of deposits (CDs), Eurodollar deposits or takings (Euro-CDs) and deposits taken under separate borrowing agreements. These funds are generally obtained through the branch's money market deposit taking activities. However, narrowly defining these instruments as deposits instead of borrowings is not universally accepted and, in fact, the negotiable money market CD and Euro-CD are widely recognized as primary borrowing vehicles. Dependence on CDs and Euro-CDs as sources of funds is discussed in Section 3230, Deposit Accounts.

Negotiable CDs and Euro-CDs are generally used by wholesale branches. They consist of deposits over \$100,000 and are not considered core funds. The major distinction between Euro-CDs and negotiable CDs is that Euro-CDs are primarily funds from offshore sources. With more diverse products entering the market, floating rate CDs and floating rate Euro-CDs are becoming more popular.

## REPURCHASE AGREEMENTS

Instead of resorting to direct borrowing, a branch may sell assets to another bank or some other party and simultaneously agree to repurchase the assets at a specified time or after certain conditions have been met. Securities and loans are often sold under repurchase agreements to generate temporary working funds. Agreements of this nature are frequently used because the cost of this type of secured borrowing is generally lower than that of unsecured borrowings, such as Federal funds purchased. Repurchase agreements should not be confused with resale agreements (also known as reverse repurchase agreements). The usual terms for sale of securities under a repurchase agreement require that, after a stated period of time, the seller repurchases the same securities at a predetermined price or yield. U.S. government and agency securities are the most common type of instruments sold under repurchase agreements because they are exempt from reserve requirements.

Management should be aware of certain considerations and potential settlement risks associated with repurchase agreements entered into in large volume with institutional investors and/or brokers. If the value of the underlying securities exceeds the price at which the repur-

chase agreement was sold, the branch could be exposed to the risk of loss in the event that the buyer is unable to perform and return the securities. This possibility is more likely if the securities are physically transferred to the institution or broker with which the branch has entered into the repurchase agreement. For this reason, branches should avoid, if possible, pledging excessive collateral. However, most transactions today do not involve the physical transfer of securities, rather they involve a book entry system which can reduce settlement risk. The branch should obtain sufficient financial information on and analyze the financial condition of those institutions and brokers with whom they engage in repurchase transactions.

Branches engaging in repurchase agreements should include these transactions when calculating their interest rate sensitivity positions. In addition, the degree to which a branch borrows through repurchase agreements should be analyzed with respect to its liquidity needs, and contingency plans should provide for alternate sources of funds in the event of a run-off of repurchase agreement liabilities.

## LINES OF CREDIT FROM CORRESPONDENT BANKS

Lines of credit with correspondent banks may be on an advised or unadvised basis. Advised (also known as committed or fee paid) lines of credit provide a reliable source of back-up funding to the branch, in that the correspondent bank is committed to lend under the specified terms of the credit facility. Unadvised lines of credit are not committed facilities and access to such funds can be denied by the correspondent bank. On occasion, branches negotiate loans from their principal correspondent banks. The loans are usually for short periods and may or may not be secured. Lines of credit to finance trade transactions evidenced by letters of credit can result in the correspondent bank financing the branch for an additional period of time, after a sight draft drawn under a letter of credit has been presented at the correspondent bank.

## SHORT-TERM DEBT

Short-term borrowings may be found in a branch, both on a direct and indirect basis. Borrowings

on a direct basis are usually evidenced by promissory notes, or through accounts with the head office or a correspondent bank. Indirect forms of borrowing include notes and trade bills rediscounted; notes, acceptances, import drafts, or trade bills sold with the branch's endorsement or guarantee; notes and other obligations sold subject to repurchase agreements; and acceptance pool participations.

common form of long-term debt is direct term borrowings from correspondent banks. Branches are usually more interested in attracting long-term funds through the U.S. capital markets for their head office than issuing long-term debt for their own utilization.

## LONG-TERM DEBT

On an infrequent basis, long-term debt borrowings may be found in a branch. The most

# Borrowed Funds

## Examination Objectives

Effective date July 1997

## Section 3220.2

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1. To determine if the policies, practices, procedures, and internal controls regarding borrowed funds are adequate.
2. To determine if branch officers are operating in conformity with the established guidelines of the head office.
3. To determine the scope and adequacy of the internal/external audit function as it relates to borrowed funds.
4. To determine compliance with laws and regulations as it relates to borrowed funds.
5. To determine if the existing level of borrowed funds is consistent with the branch's activities.
6. To determine if the existing rates paid are in line with concurrent market rates.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Borrowed Funds

## Examination Procedures

Effective date July 1997

## Section 3220.3

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1. If selected for implementation, complete or update the Internal Control Questionnaire.
2. Determine if deficiencies noted at the previous examination or by internal/external audits have been addressed by management.
3. Determine the purpose of each type of borrowing and whether the branch's borrowing posture is justified in light of its role within the FBO's network and other relevant circumstances.
4. Determine if the branch has adequate contingency plans for alternate sources of funds and if these contingency funding lines are periodically tested for availability.
5. Prepare, in appropriate report form, and discuss with appropriate management:
  - a. The adequacy of written policies regarding borrowings.
  - b. The manner in which branch officers are operating in conformance with established policy.
  - c. The existence of any unjustified borrowing practices.
  - d. Any violation of laws or regulations.
  - e. Recommended corrective action when policies, practices, or procedures are deficient; violations of laws or regulations exist; or when unjustified borrowing practices are being pursued.
6. Update the workpapers with any information that will facilitate future examinations.

**POLICY**

1. Has the head office approved a written policy which:
  - a. Outlines the objectives of the branch's borrowings?
  - b. Describes the branch's borrowing philosophy relative to risk considerations, i.e., leverage/growth, liquidity/income?
  - c. Provides for risk diversification in terms of staggered maturities, rather than solely on cost?
  - d. Limits borrowings by amount outstanding, specific type, or total interest expense?
  - e. Limits or restricts execution of borrowings by branch officers?
  - f. Provides a system of reporting requirements to monitor borrowing activity?
  - g. Requires subsequent approval of transactions?
  - h. Provides for review and revision of established policy at least annually?
- a. Handle cash?
- b. Issue official checks and drafts?
- c. Prepare all supporting documents required for payment of debt?
4. Are subsidiary records for borrowed funds reconciled with the general ledger accounts at an interval consistent with borrowing activity, and are the reconciling items investigated by persons who do not also:
  - a. Handle cash?
  - b. Prepare or post to the subsidiary records for borrowed funds?
5. Has it been determined that borrowings from U.S. bank subsidiaries conform with applicable regulatory restrictions?
6. Are corporate resolutions properly prepared as required by creditors and are copies on file for reviewing personnel?
7. Are monthly reports furnished to the head office management reflecting the activity of borrowed funds, including amounts outstanding, interest rates, interest paid to date, and anticipated future activity?

**RECORDS**

2. Does the branch maintain subsidiary records for each type of borrowing, including proper identification of the obligee and a written confirmation?
3. Is the preparation, addition, and posting of the subsidiary borrowed funds records performed or adequately reviewed by persons who do not also:

**CONCLUSION**

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

# Borrowed Funds

## Audit Guidelines

Effective date July 1997

## Section 3220.5

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1. Using an appropriate sampling technique, select items for review of supporting documentation, including terms, balances, and other appropriate details, and request a positive confirmation from the lender. Control all answered confirmations and investigate any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions or no-replies.
2. To the extent appropriate, review collateralized transactions for the sufficiency of security to cover the lender's requirements and ensure that the branch's assets pledged as collateral are clearly identified.
3. Examine supporting documents for accuracy and trace applicable entries, including proceeds, to detail records and to the general ledger.
4. Test interest computations for accuracy and trace entries to appropriate accounts.
5. Examine transactions for adherence with terms of borrowing arrangements.
6. Review all borrowings requiring head office approval for appropriate documentation and authorization.

U.S. branches of foreign banking organizations (FBOs) may hold deposits, which represent funds that branch customers have advanced and the branch is obligated to repay on demand, after a specific period of time, or after expiration of some required notice period. Definitions of deposit types (i.e., demand, savings, and NOW accounts and their respective availabilities) are outlined in the Federal Reserve Board's Regulation D and in the instructions to the Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (FFIEC 002). The nature, type, and level of deposits that a branch may accept is dependent on a variety of factors, including the licensing agency, applicable state restrictions, Federal Deposit Insurance Corporation insurance status, and the limitations imposed based on the type of office, i.e., depository or nondepository office. Management should have policies in place to ensure compliance with all applicable deposit-taking restrictions.

The majority of U.S. branches of FBOs do not maintain FDIC insurance and are therefore subject to relevant notification requirements described in the Federal Deposit Insurance-Insured and Uninsured Branches section of this manual. These wholesale branches generally may accept deposits over \$100,000 or from U.S. nonresidents. Branches, however, can accept deposits of less than \$100,000 from residents provided the branch's total retail deposits do not exceed 1 of its total deposits. Refer to FDIC Rules and Regulations Part 346 for additional information. Licensing agencies may apply additional deposit-taking restrictions, which should be incorporated into the review's scope. Uninsured branches (non-FDIC-insured) may face legal limitations on deposits but generally have greater flexibility in taking borrowed funds. Examiners should review the documentation supporting deposit and borrowed funds transactions to determine that they are properly identified and reported.

Guidelines applicable to offices with FDIC-insured deposits are also available in the section on Federal Deposit Insurance- Insured and Uninsured Branches.

Some branches use private banking departments to gather and retain large deposit bases. For more information on these departments, see the Private Banking section in this manual.

### REGULATION K SUBPART B SECTION 211.21(B)—CREDIT BALANCES

As defined in Regulation K, Subpart B, Section 211.21(b), Credit Balances, U.S. agencies, as opposed to branches, of FBOs are *not* allowed to accept deposits from U.S. citizens or residents. Agencies may, however, maintain credit balances for U.S. citizens and residents, in addition to taking deposits from foreign residents. Obligations are not considered credit balances unless they meet *all* of the following conditions:

- Arise out of, or are incidental to the exercise of other lawful banking powers, such as the disbursement of loan proceeds, receipt of wire transfer activities, or arise out of letter of credit transactions;
- Serve a specific purpose;
- Are not solicited from the general public;
- Are not used to pay routine operating expenses in the United States, such as salaries, rent, or taxes;
- Are withdrawn, within a reasonable period of time, after the specific purpose for which they were placed has been accomplished; and
- Are drawn upon in a manner reasonable in relation to the size and nature of the account.

The agency's Report of Assets and Liabilities should correctly show such credit balances.

*The remaining discussion applies to those branches that rely heavily on retail deposits as a funding source.*

### DEPOSIT DEVELOPMENT AND RETENTION PROGRAM

Branch management should adopt and implement a development and retention program for all types of deposits because of competition for funds, the need for most individuals and corporations to minimize idle funds, and the effect of disintermediation (the movement of deposits to other higher-yielding markets) on a branch's deposit base. The review of a branch's deposit development and retention program and the methods used to determine the volatility and composition of the deposit structure are important elements of the examination process. The

deposit development and retention program is often included in the funds management policy and should contain a marketing strategy, projections of deposit structure and associated costs, and a formula for comparing results against projections.

## Marketing Strategy

In determining its market strategy, management must first consider many factors, including:

- The composition of the market area economic base, especially the countries targeted by the private banking, corporate banking, or correspondent banking departments;
- The ability to employ deposits profitably;
- The adequacy of current operations (staffing and systems) and the location and size of banking quarters relative to its volume of business;
- The degree of competition from banks and nonbank financial institutions and their programs to attract deposit customers; and
- The effects of the local and foreign economies and the monetary and fiscal policies of the local and foreign government on the branch's market area.

After a deposit program is developed, management must continue to monitor those factors and correlate any findings to determine if adjustments are needed. The long term success of any deposit program relates directly to the ability of management to detect the need for change at the earliest possible time.

## Deposit Structure and Associated Costs

Management should not only look at deposit growth but also at the characteristics of the deposit structure. Management must be able to determine what percentage of the overall deposit structure is centered in stable or core deposits, in fluctuating or seasonal deposits, and in volatile deposits to properly invest such funds in view of anticipated or potential withdrawals.

It is important that internal reports with information concerning the composition of the deposit structure be provided periodically to both branch and head office management. In analyzing the deposit structure, information gathered by the

various examination procedures should be sufficient to allow the examiner to evaluate the composition of both volatile and core deposits. Management's lack of such knowledge could lead to an asset/liability mismatch, which could cause problems at a later date. Ultimately, the examiner should be satisfied that management has properly planned for the branch's future.

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

For branches with a significant deposit base, interest paid on deposits can represent the largest expense to the branch. Additional costs associated with deposits include general operating costs, promotional and advertising costs, and changes in required reserves. As a result, interest-bearing deposit accounts employed in a marginally profitable manner could have significant and lasting effects on branch earnings. Refer to the Income and Expense Section of this manual for additional information.

## Comparing Results to Projections

Management should have a formula in place for comparing results against projections. Projections should be periodically reviewed and updated throughout the fiscal year. Actual results should be periodically compared to projections and material variances should be identified and reviewed by management. Typically, the branch's annual budget will include projections for deposits and associated costs. Refer to the Income and Expense section of this manual for additional information on comparing actual results to those projected.

## SPECIAL DEPOSIT-RELATED ISSUES

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

## Abandoned Property Law

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

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

Service charges on dormant accounts should bear a direct relationship to the cost of servicing the accounts to ensure that the charges are not excessive. Management should have policies and procedures in place to review and document the basis on which service charges on dormant accounts are assessed. There have been occasions when, because of excessive charges, there were no proceeds to remit at the time the account became subject to escheat requirements and courts have required banks to reimburse the state. (Refer to the discussion on dormant accounts in the subsequent Potential Problem Areas section.)

## Bank Secrecy Act

Examiners should be aware of the Bank Secrecy Act when examining the deposit area and follow up on any unusual activities or arrangements noted. The Act was implemented by the Treasury Department's Financial Recordkeeping and Reporting of Currency and Foreign Transactions Regulation. For further information, see the Federal Reserve's Bank Secrecy Act Manual, Section 208.14 of the Federal Reserve's Regulation H, and other supervisory material. The Federal Reserve's Bank Secrecy Act Manual also includes information on "Know Your Customer" guidelines.

## Banking Hours and Processing of Demand Deposits

The Uniform Commercial Code (UCC) allows a bank or branch to establish a banking day cut-off hour of 2:00 p.m. or later for the handling of items received for deposit or presented for payment (UCC 4-108). A banking day is defined as the part of a day on which the bank or branch is open to the public for substantially all of its

banking functions (UCC 4-104(a)(3)). For branches with retail deposit-taking activities, a banking day generally includes, at a minimum, operation of a teller window and the bookkeeping and loan departments. Items received on a nonbanking day or after the cut-off hour on a banking day may be processed as if received on the following banking day.

A branch that violates the cut-off hour could be subject to civil liability for not performing its duties under other provisions of the UCC (see UCC 4-202, 4-213, 4-214, 4-301, and 4-302).

## Foreign Currency Deposits

Branches are permitted to accept deposits denominated in foreign currency. Branches should notify customers that such deposits are subject to foreign exchange risk. The branch converts such accounts to the U.S. dollar equivalents for reporting to the Federal Reserve. Examiners should verify that all reports are in order and evaluate the branch's use of such funds and management of the accompanying foreign exchange risk. Foreign currency denominated accounts are not subject to the requirements of Regulation CC, Availability of Funds and Collection of Checks. For additional information, examiners may refer to the Federal Reserve's supervisory guidance letter, SR-90-3 (IB), Foreign (Non-U.S.) Currency Denominated Deposits Offered at Domestic Depository Institutions.

## International Banking Facilities

An International Banking Facility (IBF) is a set of asset and liability accounts segregated on the books of a branch. 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. When examining an IBF, the examiner should follow the special examination procedures in the International Banking Facility section of this manual.

## Reserve Requirements

Under the Monetary Control Act of 1980 and the Federal Reserve's Regulation D, Reserve

Requirements of Depository Institutions, branches are subject to reserve requirements in the following instances:

- It is an insured branch, and its parent foreign bank has total worldwide consolidated bank assets in excess of \$1 billion; or
- It is an insured branch, and is controlled by a foreign company or by a group of foreign companies that own or control foreign banks that in the aggregate have total worldwide consolidated bank assets in excess of \$1 billion; or
- It is a branch that is eligible to apply to become an insured bank under section 5 of the Federal Deposit Insurance Act.

For reserve requirement purposes, there are two categories of deposits: transaction accounts and nontransaction accounts. Refer to the Federal Reserve's Regulation D and the FFIEC 002 instructions for specific definitions of the various types of deposits. Branches may choose to maintain reserves for discount window access.

## POTENTIAL PROBLEM AREAS

The following paragraphs discuss the types of deposit accounts and related activities that have above-average risk and, therefore, require the examiner's special attention.

### Branch-Controlled Deposit Accounts

Branch-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 regarding these accounts can cause significant loss to the branch. To ensure that such accounts are properly administered and controlled, branch and head office management must ensure that operating policies and procedures are in effect that establish acceptable purpose and use; appropriate entries; controls over posting entries; and the length of time an item may remain unrecorded, unposted, or outstanding. Internal controls that limit employee access to branch-controlled accounts, determine the responsibility for frequency of reconciliation, discourage

improper posting of items, and provide for periodic internal supervisory review of account activity are essential to efficient deposit administration.

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

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

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

### Brokered Deposits

Brokered deposits represent funds the branch obtains, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Thus, brokered deposits include both those in which the entire beneficial interest in a given branch 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 branch deposit account.

A small or medium-sized branch's dependence on the deposits of customers who reside outside of or conduct their business outside of the branch's normal service area should be closely monitored by branch and head office management, and analyzed by the examiner. Such deposits may be the product of personal relationships or good customer service; however, large out-of-area deposits are sometimes attracted by liberal credit accommodations or by offering significantly higher interest rates than competitors offer. Deposit growth due to liberal credit accommodations generally proves costly in terms of the credit risks taken relative to the benefits received from corresponding deposits, which may be less stable. Deposit development and retention policies should recognize the limits imposed by prudent competition and the branch's service area.

Banking organizations have historically relied to a limited extent upon funds obtained through deposit brokers to supplement their traditional funding sources. A concern regarding the activities of deposit brokers is that the ready availability of large amounts of funds through the issuance of such obligations undercuts market discipline, particularly in insured depository institutions. To compensate for the high rates typically offered for brokered deposits, institutions holding them tend to seek assets that carry commensurately high yields. These assets can often involve excessive credit risk or cause the branch to take on undue interest-rate risk through a mismatch in the maturity of assets and liabilities.

In light of these concerns, certain restrictions on the use of brokered deposits were developed under section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), which apply to federally-insured branches. Section 301 of FDICIA amended section 29 of FDIA to prohibit undercapitalized institutions from accepting funds obtained, directly or indirectly, by or through any deposit broker for deposit into one or more deposit accounts. Adequately capitalized institutions may accept such funds only if they first obtain a waiver from the FDIC, while well-capitalized institutions may accept such funds without restriction. Refer to FDIC regulations and guidelines for information on how these requirements are applied to federally-insured branches. Each examination should include a review for compliance with the FDIC's limitations on the

acceptance of brokered deposits and guidelines on interest payments.

The use of brokered deposits should be reviewed during all on-site examinations, even for those institutions not subject to the FDIC's restrictions. In light of the potential risks accompanying the use of brokered deposits, the examination should focus on:

- The rate of growth and the credit quality of the loans or investments funded by brokered deposits;
- Whether brokered funds are in turn sold to branch customers;
- The corresponding quality of loan files, documentation, and customer credit and deposit information;
- The ability of branch management to adequately evaluate and administer these credits and deposits and manage the resulting growth;
- The 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;
- The composition and stability of the deposit sources and the role of brokered deposits in the branch's overall funding position and strategy; and
- The effect of brokered deposits on the branch's risk standing and whether or not the use of brokered deposits constitutes an unsafe and unsound banking practice.

## 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 (i.e., the time required for the bank of deposit to collect from the paying bank); and the depositor initiates the transaction with the knowledge that sufficient collected funds will not be available to support the amount of the checks drawn on all of the accounts.

The key to this deceptive practice, the most prevalent type of check fraud, is the ability to draw against uncollected funds. However, drawing against uncollected funds in and of itself does not necessarily indicate kiting. Kiting only occurs when the aggregate amount of drawings exceeds the sum of the collected balances in all accounts. Nevertheless, because drawing against

uncollected funds is the initial step in the kiting process, management should closely monitor this activity. The requirements of Regulation CC, Availability of Funds and Collection of Checks, increased the risk of check kiting and should be addressed by management in the branch's policies and procedures.

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

## Delayed Disbursement Practices

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

Delayed disbursement arrangements could give rise to supervisory concerns because a branch may unknowingly incur significant credit risk through such arrangements. The remote location of institutions offering delayed disbursement arrangements often increases the collection time for checks by at least a day or more.

The primary risk is payment against uncollected funds, which could be a method of extending unsecured credit to a depositor. Absent proper and complete documentation regarding the creditworthiness of the depositor, paying items against uncollected funds could be considered an unsafe or unsound banking practice. Furthermore, such loans, even if properly documented, might exceed the branch's prudential lending limit, if applicable, for loans to one customer.

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

## Deposit Sweep Programs/Master Note Arrangements

Deposit sweep programs/master note arrangements (sweep programs) can be implemented on a branch level or on a FBO level. On a branch level, these sweep programs exist primarily to facilitate cash management needs of branch customers, thereby retaining customers who might otherwise move their account to an entity offering higher yields. On a FBO level, the sweep programs are maintained with customers at the branch level and the funds are upstreamed to the FBO as part of its overall funding strategy. Sweep programs use an agreement with the branch's deposit customers (typically corporate accounts) that permits these customers to reinvest amounts in their deposit accounts above a designated level in overnight investments. These obligations include such instruments as commercial paper, program notes, and master note agreements.

For insured branches, the disclosure agreement regarding the sale of these types of non-deposit debt obligations should include a statement indicating that these instruments are not federally insured deposits or obligations of or guaranteed by an insured depository institution. In addition, insured branches and their related parties and subsidiaries that have issued or plan to issue nondeposit debt obligations should not market or sell these instruments in any public area of the branch where retail deposits are accepted, including any lobby area of the branch. This requirement exists to convey the impression or understanding that the purchase of such

obligations by retail depositors of the federally-insured branch can, in the event of default, result in losses to individuals who believed they had acquired federally-insured or guaranteed obligations.

### *Branch Policies and Procedures*

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

### *Application of Deposit Proceeds*

In view of the extremely short-term maturity of most sweep accounts, branches are expected to exercise great care when investing the proceeds. Branches, from which deposit funds are swept, have a fiduciary responsibility to their customers to ensure that such transactions are conducted properly. Appropriate uses of the proceeds of deposit sweep funds are limited to short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.<sup>1</sup> Use of such proceeds to finance mismatched asset positions, such as those involving leases, loans, or loan participations, can lead to liquidity prob-

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

lems and are not considered appropriate. The absence of a clear ability to redeem overnight or extremely short-term liabilities when they become due should generally be viewed as an unsafe and unsound banking activity.

### *Funding Strategies*

A key principle underlying the Federal Reserve's supervision of banking organizations is that FBOs should operate in a way that promotes the soundness of their U.S. operations. FBOs are expected to avoid funding strategies or practices that could undermine public confidence in the liquidity or stability of their U.S. operations. Any funding strategy should maintain an adequate degree of U.S. dollar liquidity at the U.S. operation and the FBO, if appropriate. Branch management should avoid, to the extent possible, allowing sweep programs to serve as a source of funds for inappropriate uses at the FBO or at an affiliate. Concerns exist in this regard, because funding mismatches can exacerbate an otherwise manageable period of financial stress and, in the extreme, undermine public confidence in the FBO's viability.

### *Funding Programs*

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

### *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 branch. Branch management should establish standards that specifically outline the

branch's policy for the effective control of dormant accounts, addressing:

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

## Employee Deposit Accounts

Historically, examiners have discovered various irregularities and potential wrongdoing through reviews of employee deposit accounts. As a result, if employees are permitted to maintain accounts at the branch, branch policy should establish standards that segregate or specially encode employee accounts and encourage periodic internal supervisory review. In light of these concerns, examiners should review related branch procedures and practices, taking appropriate measures when warranted.

## Overdrafts

The size, frequency, and duration of deposit account overdrafts are matters that should be governed by branch policy and controlled by adequate internal controls, practices, and procedures. Overdraft charges should be significant enough to discourage abuse. Overdraft authority should be approved in the same manner as lending authority and should never exceed the employee's lending authority. Systems for monitoring and reporting overdrafts should emphasize a secondary level of administrative control that is distinct from other lending functions so account officers, who may be less than objective, do not allow influential customers to exploit their overdraft privileges. An examiner should also be aware that Regulation O addresses the payment of overdrafts to executive officers of a federally-insured branch. It is the responsibility

of branch management, with oversight from head office, to review overdrafts as they would any other extension of credit. In most cases, overdrafts outstanding for more than 30 days, which lack mitigating circumstances, should be considered for charge-off.

## Payable-Through Accounts

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

## Zero-Balance Accounts

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

- *Wire Transfers*;
- *Depository Transfer Checks*—a bank-prepared payment instrument used to transfer money

from a corporate account in one bank to another bank;

- *Concentration Accounts*—a separate corporate demand deposit account at the same bank used to cover deficits or channel surplus funds relative to the ZBA; and
- *Extended Settlement*—a cash management arrangement that does not require the corporate customer to provide same-day funds for payment of its checks.

Because checks are covered before the close of business on the day they arrive, the branch's exposure is not reflected in the financial statement. The branch, however, assumes risk by paying against uncollected funds, thereby creating unsecured extensions of credit during the

day (referred to as a daylight overdraft between the account holder and the branch). If these checks are not covered, an overdraft occurs, which will be reflected on the branch's financial statement.

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

# Deposit Accounts

## Examination Objectives

Effective date July 1997

## Section 3230.2

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1. To determine if the policies, practices, procedures, and internal controls regarding deposit accounts are adequate.
2. To determine if branch officers and employees are operating in conformance with the branch's established guidelines.
3. To evaluate the deposit structure and determine its characteristics and volatility.
4. To determine the scope and adequacy of the audit function.
5. To determine compliance with applicable laws and regulations.
6. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Deposit Accounts

## Examination Procedures

Effective date July 1997

## Section 3230.3

1. Determine if deficiencies noted at the previous examination or by internal/external audits have been adequately addressed by management.
  2. Check applicable restrictions on the nature, type, and level of deposits that can be maintained by the branch.
  3. If selected for implementation, complete the ICQ.
  4. In conducting an examination, the examiner should use available branch copies of print-outs plus transactions journals, microfiche, or other visual media to minimize expense to the branch. However, if copies of these reports are not available, the examiner should determine and request the information necessary to complete the examination procedures and, if required, the internal control questionnaire. Obtain or prepare, as applicable, the reports indicated below, which are used for a variety of purposes, including the assessment of deposit volatility and liquidity, adequacy of internal controls, verification of information contained on required regulatory reports, and assessment of loss.
    - a. For demand deposits and other transaction accounts:
      - Trial balance
      - Overdrafts
      - Unposted items
      - Nonsufficient funds (NSF) report
      - Dormant accounts
      - Uncollected funds
      - Due to banks
      - Trust department funds
      - Significant activity
      - Suspected kiting report
      - Matured certificates of deposits without an automatic renewal feature
      - Large balance report
    - b. For official checks:
      - Trial balance(s)
    - c. For time deposits:
      - Trial balance(s)
      - Unposted items
      - Dormant Accounts
      - Trust department funds
      - Large balance report
      - Money market accounts
      - Negotiable certificates of deposits
        - Maturity reports
  - d. For deposit sweep programs/master note arrangements:
    - List individually by deposit type and amount
  - e. For brokered deposits:
    - List individually by deposit type, including amount and rate
  - f. For foreign currency deposits:
    - List of accounts and currency type
  - g. For employee deposit accounts:
    - List individually by deposit type, including amount and rate
    - Overdrafts
    - Monthly account activity, including dollar and transaction volume
5. If an agency, for credit balances:
    - a. Review the agency's policy to ensure compliance with Subpart B Section 211.21(b) of Regulation K dealing with credit balances.
    - b. Determine that controls are in place to monitor compliance with the regulation.
    - c. Select a sample of credit balances and review transaction activity to determine if such balances are being used in accordance with the regulation.
  6. Review the reconcilements of all types of deposit accounts and verify the balances to department controls and the general ledger, then:
    - a. Determine if reconciliation items are legitimate and if they clear within a reasonable time frame.
    - b. Retain custody of all trial balances, only if necessary and practical.
  7. Test documentation on the underlying transactions reported as borrowed funds to ensure that these do not better fit the definition of deposits. Refer to the Borrowed Funds section of this manual and appropriate sections of the Board's Regulation D for additional guidance. If determined to be deposits, include such transactions in the review of deposits.
  8. Review the reconciliation process for branch controlled accounts, such as official checks and escrow deposits, by:
    - a. Determining if reconciling items are legitimate and if they clear within a reasonable time frame.

- b. Scanning activity in such accounts to determine the potential for improper diversion of funds for various uses, such as:
  - Political contributions
  - Loan payments (principal or interest)
  - Personal use
- c. Determine if checks are being processed before their related credits.
9. Review the branch's operating procedures and reconciliation process relative to suspense accounts and determine if:
  - a. The disposition of unidentified items is completed in a timely fashion.
  - b. Reports are generated to periodically inform management of the type, age, and amounts of items in such accounts.
  - c. Employees responsible for clearing suspense account times are not shifting the items between accounts.
10. Evaluate the effectiveness of the policies, procedures, and management's reporting methods regarding overdrafts and drawings against uncollected funds.
  - a. Concerning overdrafts, determine if:
    - Officer-approval limits have been established
    - A formal system of review and approval is in effect
  - b. Ascertain the existence of formal overdraft protection, and, if it exists:
    - Obtain a master list of all depositors with formal overdraft protection
    - Obtain a trial balance indicating advances outstanding and compare it with the master list to ensure compliance with approved limits
    - Cross-reference the trial balance or master list to examiner loan line sheets
    - Review credit files on significant formal agreements not cross-referenced above
  - c. Concerning drawings against uncollected funds, determine if:
    - The uncollected funds report reflects balances as being uncollected until they are actually received
    - Management is comparing reports of significant changes in balances and activity volume to uncollected funds reports
    - Management knows the reasons why a depositor is frequently drawing against uncollected funds
    - A reporting system to inform senior management of significant activity in this area has been instituted
- Appropriate employees clearly understand the mechanics of drawing against uncollected funds and the risks involved, especially in the area of potential check kiting operations
- d. Upon completing steps 10.a., 10.b., and 10.c., the examiner should:
  - Cross-reference overdraft and uncollected funds reports to examiner loan line sheets;
  - For those depositors not cross referenced in the preceding step, review the credit files of depositors with significant overdrafts, if available, or the credit files of depositors who frequently draw significant amounts against uncollected funds;
  - Request management to charge off overdrafts deemed to be uncollectible by examiners; and
  - Submit a list of the following items to the appropriate examiner:
    - Overdrafts considered loss, indicating borrower and amount.
    - Aggregate amounts overdrawn 30 days or more, for inclusion in past due statistics.
11. Review the branch's deposit development and retention policy, which is often included in the funds management policy.
  - a. Determine if the policy addresses deposit structure and related interest costs, including the percentages of time deposits and demand deposits of:
    - Individuals
    - Corporations
  - b. Determine if the policy requires periodic reports to management, comparing the accuracy of projections with results.
  - c. Assess the reasonableness of the policy and ensure that it is routinely reviewed by management.
12. If a deposit sweep program/master note arrangement exists, review for approval of related policies and procedures by head office management.
13. For branches with deposit sweep programs/master note arrangements (sweep programs), compare practices for adherence to approved policies and procedures, including a review of:
  - a. The purpose of the sweep program: is it strictly a customer accommodation

- transaction or is it intended to fund certain assets at the foreign banking organization (FBO) level or at an affiliate? Review funding transactions in light of liquidity and funding needs of the FBO by referring to the manual section on Funds Management and Liquidity.
- b. The eligibility requirements used by the branch to determine the types of customers and accounts that may participate in a sweep program, including:
- A list of customers participating in sweep programs, with dollar amounts of deposit funds swept on the date of examination.
  - The name of the recipient(s) of swept funds and:
    - If an affiliate of the branch (i.e., FBO), a schedule of the instruments into which the funds were swept, including the effective maturity of these instruments.
    - If an unaffiliated third party, determine if the branch adequately evaluates the third party's financial condition at least annually. Verify if a fee is received by the branch for the transaction and, if so, that it is disclosed in customer documentation.
- c. Whether the proceeds of sweep programs are invested only in short-term bank obligations, short-term U.S. government securities, or other highly liquid, readily marketable, investment-grade assets that can be disposed of with minimal loss of principal.
- d. Whether the branch has issued or plans to issue nondeposit debt obligations in any public area of the branch where retail deposits are accepted, including any lobby area of the branch.
- e. Completed sweep program documents to determine if:
- In the case of federally-insured branches, signed documents boldly disclose that the instrument into which deposit funds will be swept is not insured by the FDIC and is not an obligation of or guaranteed by the branch.
  - Proper authorization for the instrument exists between the customer and an authorized representative of the branch.
- Signed documents properly disclose the name of the obligor and type of instrument into which the depositor's funds will be swept. If funds are being swept into U.S. government securities held by the branch or FBO, verify that adequate confirmations are provided to customers in accordance with the Government Securities Act of 1986. (This Act requires that all transactions subject to a repurchase agreement be confirmed in writing at the end of the day of initiation and that the confirmation covers specific securities. If any other securities are substituted that result in a change of issuer, maturity date, par amount, or coupon rate, another confirmation must be issued at the end of the day during which the substitution occurred. Because the confirmation or safekeeping receipt must list specific securities, pooling of securities for any type of sweep program involving government securities is not permitted. Additionally, if funds are swept into other instruments, similar confirmation procedures should be applied.)
  - Conditions of the sweep program are stated clearly, including the dollar amount (minimum or maximum amounts and incremental amounts), time frame of sweep, time of day sweep transaction occurs, fees payable, transaction confirmation notice, pre-payment terms, and termination notice.
  - The length of any single transaction under sweep programs in effect has not exceeded 270 days and the amount is \$25,000 or more (as stipulated by SEC policy). Ongoing sweep program disclosures should occasionally be sent to the customer to ensure that the terms of the program are updated and the customer understands the terms.
- f. In the case of federally-insured branches, samples of advertisements (newspaper, radio and television spots, etc.) by the branch for sweep programs to determine if the advertisements:
- Boldly disclose that the instrument into which deposit funds are swept is not insured by the FDIC and is not an obligation of, or guaranteed by, the branch.

- Are not enclosed with insured deposit statements mailed to customers.
- g. Whether the sweep program has had a negative effect on branch liquidity or has the potential to undermine public confidence in the branch. Additionally:
- Review the branch's Federal funds and other borrowing activities to ascertain whether borrowings appear high. If so, compare the branch's borrowing activity with daily balances of aggregate sweep transactions on selected dates, to see if a correlation exists.
  - If sweep activity is significant, compare the rates being paid on swept deposits with the yields received on the invested funds and with the rates on other overnight funding instruments, such as fed funds, to determine if they are reasonable.
14. Forward the following to the examiner assigned to Funds Management and Liquidity:
- a. The amount of any deposit decline or deposit increase anticipated by management (the time period will be determined by the examiner performing liquidity and funds management).
  - b. A listing by name and amount of any depositor controlling a significant percentage of total deposits.
  - c. A maturity schedule of certificates of deposit, detailing maturities within the next 30, 60, 90, 180, and 360 days.
  - d. An assessment of the overall characteristics and volatility of the deposit structure.
15. Assess the volatility and the composition of the branch's deposit structure.
- a. Review the list of time certificates of deposit of \$100,000 or more and related management reports to determine:
    - The aggregate dollar volume of bearer CDs, if significant.
    - The aggregate dollar volume of accounts of depositors by country.
    - If the branch is paying competitive rates on CDs.
    - The aggregate dollar volume of money market CDs with interest rates higher than current publicly quoted rates within the industry, if significant.
    - The dollar amount of brokered CDs, if any.
  - b. Select, at a minimum, the 10 largest accounts to determine if the retention of those accounts depends on:
    - Criticizable loan relationships.
    - Liberal service accommodations, such as permissive overdrafts and drawings against uncollected funds.
    - Interbank correspondent relationships.
    - Deposits obtained as a result of special promotions.
    - A recognizable trend with respect to:
      - Frequent significant balance fluctuations.
      - Seasonal fluctuations.
      - Nonseasonal increases or decreases in average balances.
  - c. Elicit management's comments to determine, to the extent possible:
    - The potential renewal of large CDs that mature within the next 12 months.
    - If a significant dollar volume of accounts is concentrated in customers engaged in a single business or industry.
16. Test for compliance with the applicable laws and regulations listed below by performing the following procedures:
- a. For federally-insured branches, Regulation O (12 CFR 215), Loans to Executive Officers, Directors, and Principal Shareholders of Member Banks:
    - Review the overdraft listing to ensure that the branch has not paid an overdraft on any account of an executive officer, unless the payment is made according to:
      - A written, preauthorized, interest-bearing extension of a credit plan providing for a method of repayment or
      - A written, preauthorized transfer from another account of that executive officer.
- Payment of inadvertent overdrafts in an aggregate amount of \$1,000 or less is not prohibited, provided the account is not overdrawn more than five business days and the executive officer is charged the same fee charged other customers in similar circumstances. Overdrafts are extensions of credit and must be included when considering each insider's lending limits and other extensions of credit restrictions and the aggregate lending limit for all outstanding extensions of credit by the branch

- to all insiders and their related interests.
- b. 12 USC 1972(2), Loans to Executive Officers, Directors, and Principal Shareholders of Correspondent Banks:
    - Review the overdraft listing to ensure that no preferential overdrafts exist from the branch under examination to the executive officers, directors, or principal shareholders of its correspondent bank.
  - c. Section 301 of the Federal Deposit Insurance Corporation Improvement Act of 1991. Refer to the section on Federal Deposit Insurance-Uninsured and Insured Branches of this manual for procedural guidance.
  - d. Regulation D (12 CFR 204), Reserve Requirements of Depository Institutions:
    - Review the accuracy of the deposit data used in the branch's reserve requirement calculation for the examination date. In cases where a branch issues nondeposit, uninsured obligations that are classified as deposits in the calculation of reserve requirements, examiners should determine if these items are properly categorized.
  - e. Local escheat laws:
    - Determine if the branch is adhering to the local escheat laws with regard to all forms of dormant deposits, including official checks.
17. If applicable, determine if the branch is appropriately monitoring and limiting the foreign exchange risk associated with foreign currency deposits.
  18. Discuss overall findings with branch management and prepare report comments on:
    - a. Policy deficiencies.
    - b. Noncompliance with policies.
    - c. Weaknesses in supervision and reporting.
    - d. Violations of laws and regulations.
    - e. Possible conflicts of interest.

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**OPENING DEPOSIT ACCOUNTS**

1. Are the opening of new accounts and access to unused new account records and certificate of deposit (CD) forms handled by an employee who is not a teller or who cannot make internal entries to customer accounts or general ledger?
2. Does the branch have a written “Know Your Customer” policy?
  - a. Do new account applications require sufficient information to clearly identify the customer?
  - b. Are “starter” checks issued only after verification of data on new transaction account applications?
  - c. Are checkbooks and statements mailed only to the address of record? If not, is a satisfactory explanation and description obtained for any other mailing address (post office boxes, friend or relative, etc.)?
  - d. Are employees responsible for opening new accounts trained to screen depositors for signs of check kiting?
  - e. Will the branch open new accounts with incomplete documentation?
3. Are accounts referred to the branch by representative offices? If so, are the representatives employees of the foreign banking organization? Are accounts referred to the branch by other related offices or affiliates? If so, who refers them and why are they booked at the branch? Do these representatives receive “Know Your Customer” training?
4. Are new account applications and signature cards reviewed by an officer prior to opening the account?

**CLOSING DEPOSIT ACCOUNTS**

5. Are signature cards for closed accounts promptly pulled from the active account file and placed in a closed file? Are closed account lists circulated to the appropriate management?

**REGULATION K SUBPART B  
SECTION 211.21(B)—CREDIT  
BALANCES**

6. Does the agency have a written policy that addresses credit balances?
7. Does the agency refuse to accept deposits from residents of the United States?
8. Does the agency’s system for monitoring credit balances include a continuing review of checks drawn on the account to ensure that the checks are not being used to pay for routine operating expenses in the United States?
9. Do customer deposit files contain sufficient documentation that show the foreign nature of the deposit or foreign citizenship or residency of the customer?
10. Are private banking officers or other agency personnel who solicit or open deposit accounts knowledgeable of the regulation’s limitations on the agency’s deposit-taking powers?

**DEPOSIT ACCOUNT RECORDS**

11. Is the preparation of input and posting of subsidiary demand deposit records performed and/or adequately reviewed by persons who do not also:
  - a. Accept or generate transactions?
  - b. Issue official checks and/or handle funds transfer transactions?
  - c. Prepare or authorize internal entries (return items, reversals, and direct charges, such as loan payments)?
  - d. Prepare supporting documents required for disbursements from an account?
  - e. Perform maintenance on the accounts, such as change of address, stop payments, holds, etc.?
12. Does the branch perform reconciliations for each deposit account category by individuals not engaged in accepting or preparing transactions or in data entry to customers’ accounts?
13. Do periodic reports prepared for management provide an aging of adjustments and differences and detail the status of significant adjustments and differences?

14. Are in-process, suspense, interoffice and other accounts related to deposit accounts controlled or closely monitored by persons who do not have posting or reconciliation duties?
15. Are periodic reports prepared for management on open items in suspense, in-process, interoffice and other deposit accounts and do the reports include aging of items and the status of significant items?
16. Does the branch segregate the deposit account files of:
  - a. Employees and officers?
  - b. The business interests of, or controlled by, employees and officers?
17. Are posting and check filing separated from statement preparation?
18. Are statements mailed or delivered to all customers, as required by the branch's deposit account agreement and in a controlled environment that precludes any individual from receiving any statement not specifically authorized by the customer or branch policy?
- f. Require a written request from the customer and verification of the customer's signature before releasing an account from the controlled environment?
20. Are accounts for which contact cannot be reestablished and do not reflect recent activity removed from active files and clearly classified as dormant?
21. Before returning a dormant account to active status, are transactions reactivating the account verified, independent confirmations obtained directly from the customer, and approval obtained for an officer who cannot approve transactions on dormant accounts?

## INACTIVE ACCOUNTS

22. Are demand accounts that have been inactive for one year and time accounts that have been inactive for three years classified as inactive? If not, state the time period.
23. Does the branch periodically review the inactive accounts to determine if they should be placed in a dormant status and are decisions to keep such accounts in active files documented?

## DORMANT ACCOUNTS AND RETURNED MAIL

19. Does the branch have formal policies and procedures for the handling of dormant accounts and customers' transaction and interest statements that are returned by the post office as undeliverable? Does the policy:
  - a. Require statements to be periodically mailed on dormant accounts? If so, how often?
  - b. Prohibit the handling of such statements by (1) account officer and (2) other individuals with exclusive control of accounts?
  - c. Require positive action to follow up on obtaining new addresses?
  - d. Require that statements and signature cards for accounts that cannot be contacted (the mail is returned more than once or marked "deceased") be placed into a controlled environment?
  - e. Require the branch to change the address on future statements to the department of the branch (controlled environment) designated to receive returned mail?

## HOLD MAIL

24. Does the branch have a formal policy and procedure for handling statements and documents that a customer requests not to be mailed but will be picked up at a location within the branch? Does the policy:
  - a. Require that statements will not be held by an individual (an account officer, branch manager, bookkeeper, etc.) who could establish exclusive control over entries to and delivery of statements for customer accounts?
  - b. Discourage such arrangements and grant them only after the customer provides a satisfactory reason for the arrangement?
  - c. Require the customer to sign a statement describing the purpose of the request and the proposed times for pick-up and designate the individuals authorized to pick up the statement?
  - d. Require maintenance of signature cards for individuals authorized to pick up statements and compare the authorized signatures to those who sign for statements held for pick-up?

- e. Prohibit the delivery of statements to officers and employees requiring special attention, unless it is part of the formal “hold mail” function?
25. Is a central record maintained in a control area that does not originate entries to customers’ accounts and identify each “hold mail” arrangement, the designated location for pick-up, and the scheduled pick-up times? Does the control area:
    - a. Maintain current signature cards of individuals authorized to pick up statements?
    - b. Obtain signed receipts showing the date of pick-up and compare the receipts to the signature cards?
    - c. Follow up on the status of statements not picked up as scheduled?
  26. Does management review activity in “hold mail” accounts that have not been picked up for extended periods of time (for example, one year) and, where there is no activity, place the accounts in a dormant status?
    - a. Is the computation of the uncollected funds position based on reasonable check collection criteria?
    - b. Can the reports or a separate account activity report reasonably be expected to detect potential kiting conditions?
    - c. If reports are not generated for time transaction accounts, is a system in place to control drawings against uncollected funds?
  35. Do authorized officers review the uncollected funds reports and approve drawings against uncollected funds within established limits?
  36. Are accounts that frequently appear on the uncollected funds and/or kite suspect reports reviewed, regardless of account balances? (For example, accounts with simultaneous large debits and credits can reflect low balances.)

## OTHER MATTERS

### OVERDRAFTS

27. Are officer overdraft authorization limits formally established?
28. Does the branch require an authorized officer to approve overdrafts?
29. Is an overdraft listing prepared daily for demand deposit and time transaction accounts?
30. For branches processing overdrafts that are not automatically approved (“pay none” system), is the insufficient funds report circulated among branch officers?
31. Are overdraft listings circulated among the officers?
32. Are the statements of accounts with large overdrafts reviewed for irregularities?
33. Is a record of large overdrafts included in the monthly report to head office management and does it include the overdraft origination date?

### UNCOLLECTED FUNDS

34. Does the branch generate a daily report of drawings against uncollected funds for demand deposits and time transaction accounts?
  - a. Are account maintenance activities (change of address, status changes, rate changes, etc.) separated from data entry and reconciling duties?
  - b. Do all internal entries, other than service charges, require the approval of appropriate supervisory personnel?
  - c. If not included in the internal/external audit program, are employees’ and officers’ accounts, accounts of their business interests, and accounts controlled by them periodically reviewed for unusual or prohibited activity?
40. For unidentified deposits:
  - a. Are deposit slips kept under dual control?
  - b. Is their disposition approved by an appropriate officer?
41. For returned checks, unposted items, and other rejects:
  - a. Are daily listings of such items prepared?
  - b. Are all items reviewed daily and is disposition of items required within a reasonable time period? If so, indicate the time period.
  - c. Are reports prepared for management showing items not disposed of within the established time frames?
42. Are accounts with a “hold-balance” status—those accounts on which court orders have been placed, those pledged as security to

- customers' loans, those pending the clearing of a large check, and those where the owner is deceased "blocked-out" for transactions unless approved by appropriate management?
43. For signature cards on deposit accounts:
    - a. Are procedures in effect to guard against the substitution of false signatures? Describe the procedures.
    - b. Are signature cards stored to preclude physical damage?
    - c. Are signatures compared for withdrawals and cashed checks? Describe the procedures.
  44. Are separate general ledger accounts maintained for each type of official check?
  45. As to the types of checks issued:
    - a. Are multicopy checks and certified check forms used? If not, are detailed registers of disbursed checks maintained?
    - b. Are all checks prenumbered and issued in sequence?
    - c. Is check preparation and issuance separate from recordkeeping?
    - d. Is the signing of checks in advance prohibited?
    - e. Do procedures prohibit issuance of a check before the credit is processed?
  46. Is the list authorizing branch personnel to sign official checks kept current? Does the list include changes in authorization limits, delete employees who no longer work at the branch, and indicate employees added to the list?
  47. Are appropriate controls in effect over check signing machines (if used) and certification stamps?
  48. Are voided checks and certified check forms promptly defaced and filed with paid checks?
  49. If reconcilements are not part of the overall deposit reconciliation function:
    - a. Are outstanding checks listed and reconciled regularly to the general ledger? If so, how often?
    - b. Is permanent evidence of reconcilements maintained?
    - c. Is there clear separation between preparation of checks, data entry, and reconciliation?
    - d. Are the reconcilements reviewed regularly by an authorized officer?
    - e. Are reconciliation duties rotated on a formal basis in branches where size precludes full separation of duties between data entry and reconciliation?
    - f. Are authorized signatures and endorsements checked by the filing clerk?
  50. For supplies of official checks:
    - a. Are records of unissued official checks maintained centrally and at each location storing them?
    - b. Are periodic inventories of unissued checks independently performed?
    - c. Do the inventories include a description of all checks issued out of sequence?
    - d. If users are assigned a supply, is that supply replenished on a consignment basis?
  51. Are procedures in effect to preclude certification of checks drawn against uncollected funds?

## CONCLUSION

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

# Deposit Accounts

## Audit Guidelines

Effective date July 1997

## Section 3230.5

It should be noted that some audit guidelines may not be easily implemented due to the foreign residence of many branch customers. Therefore, the examiner should exercise judgment in implementing these guidelines.

1. Test the addition of all trial balances and the reconciliation to the general ledger.
2. Using appropriate techniques, sample deposits of all types from their respective trial balances and:
  - a. Where appropriate, verify that essential account documentation contains, in a conspicuous manner, disclosure of the accounts' noninsured FDIC status.
  - b. Where necessary, prepare and mail confirmation forms, followed by second requests, to selected depositors.
  - c. Follow up on any no-replies or exceptions and resolve differences.
3. For transaction accounts selected in step 2:
  - a. Verify the computation of service charges for at least one account from each type of transaction account selected and trace them to the appropriate income account.
  - b. Determine, on a test basis, if insufficient funds and overdraft charges are properly collected and trace them to the appropriate income account.
  - c. Determine the reasons for statements noted for "no mail" or "hold for pick up" and examine appropriate authorization signed by the customer.
  - d. Determine if a properly signed authority to charge is in evidence for accounts that have an automatic deduction by the branch.
  - e. Investigate branch-controlled accounts, such as dealers' reserves and cash/collateral accounts, to determine the validity of entries and of notification procedures to the customer of activity.
  - f. Determine if unidentified funds are properly segregated, that disposition is on a timely basis, and that items are transferred to a dormant account after one year.
  - g. Mail cut-off statements to include debit and credit memos and drafts, and mail an appropriate reconciling form to due to banks accounts selected. Have the reconciliation completed and returned. Investigate significant items used to reconcile and follow through to disposition.
4. Review the reports on drawings against uncollected funds and significant changes to determine possible kiting. Request statements and copies of checks and deposit media to further investigate those selected. If the period for preparing uncollected funds reports is not at least 3 days, perform the following steps:
  - Look at 5 days of reports on uncollected funds, large balances, and significant changes for unusual depositor activity. Select account names and numbers that appear on the reports twice or more and eliminate large depositors who are known to deposit cash or their own checks to corporate clearing accounts.
  - For the remaining accounts, review canceled checks and deposit slips or cash letter items to determine if checks paid and checks deposited are controlled by the same or related parties.
4. For time deposit accounts selected in step 2:
  - a. Determine the reasons for savings account statements noted for "hold for pick-up" or "no mail" and examine appropriate authorizations signed by the customers.
  - b. Determine that accounts pledged are noted on the trial balance to prevent withdrawal of funds without officer approval.
  - c. Review the debit and credit entries to dormant accounts and determine validity and conformity to branch policy.
  - d. Verify and detail the written contracts between the branch and its trust department regarding the trust department's time open account.
  - e. Determine if unidentified funds are properly segregated and if disposition is on a timely basis. Ensure that items are

transferred to a dormant account after one year.

5. For official checks:
  - a. If accounts are on computer, reconcile the cut-off statements as of the audit date to bookkeeping totals and run a list of duplicate outstanding checks.
  - b. If accounts are manual, run a tape listing of the outstanding checks or the check register and balance to the general ledger totals.
  - c. Review the copies of the outstanding checks for unusual items, stale-dated checks or any checks to persons or organizations that may be in violation of the Foreign Corrupt Practices Act or Federal Campaign Acts.
  - d. Determine that stale checks are segregated and review the entries to ascertain validity.
  - e. Determine that all outstanding checks have been included as liabilities by controlling paid checks for a number of days after the audit has begun and:
    - Indicate any checks paid before the liability was posted.
    - Inspect the paid checks for authorized signatures and endorsements.
  - f. Determine if the branch is issuing checks in numerical sequence and make an
6. Compare the accounts selected from the last audit to the current trial balance to determine if any of those accounts were closed or, if none were noted, select accounts from the closed account list and send confirmations.
7. Review stop-payment orders and compare a representative number to the trial balance to determine if accounts are properly noted.
8. Obtain or prepare a schedule showing the accrued interest balances and the deposit balances at each quarter-end since the last audit and investigate significant fluctuations or trends.
9. Test interest expense by computing interest expense based on average deposits and interest rates on a quarterly basis. Compare the computed amount to the actual recorded expenses.
10. If the branch uses prenumbered CD forms, determine that certificates are issued in numerical order. Inventory the unissued certificates and reconcile the inventory to the control list and resolve any differences.

Head office and other offices of the foreign banking organization (FBO) frequently serve as a primary funding source for a branch, in which case the branch will be in a net due to position with related offices. This situation is commonly found in a wholesale branch or a branch that is restricted by its license from accepting deposits. Funding for these offices is typically provided by related offices and/or interbank borrowings. A retail branch, on the other hand, may be able to accept deposits and thus be a net provider of funds to related offices or in a net due from position. Examiners will find that the overall level, nature, and significance of the branch's funding relationship with related offices is influenced by a number of factors, including comparative funding costs in the home country versus the United States and the branch's role, if any, in the overall U.S. funding strategy of the FBO. The examiner's role is to evaluate these factors, identify any concerns, and recommend corrective action, if appropriate.

The evaluation of the branch's funding relationship with related parties is part of the overall evaluation of the branch's liquidity position and should thus be conducted jointly. This section provides specific guidance on the interoffice funding aspect of liquidity, which should be supplemented by referring to the Funds Management and Liquidity section of this manual.

To evaluate a funding relationship between a branch and its related offices or affiliates, examiners should begin by reviewing the branch's most recent quarterly call report-Report of Assets and Liabilities (FFIEC 002), the annual assessment of the FBO's combined U.S. operations, and the FBO's annual strength-of-support assessment. A review of recent FFIEC 002 reports will give the examiner information on the branch's historical level and trend in interoffice funding, which should be used in discussions with management on the nature of the branch's future interoffice funding position. Schedule M of the call report summarizes the gross due from/due to position with related parties and shows whether the branch is in a net due to or due from related parties position.

For FBOs with multiple U.S. operations, the U.S. operations assessment should provide information on the past level and flow of funds among its combined U.S. operations, which should also provide a basis for reviewing the

branch's current and future interoffice funding position, if any. In conducting this review, special attention should be paid to any funding relationship between the branch and a U.S. affiliate bank owned or controlled by the FBO. Such a relationship should be scrutinized to verify compliance with Sections 23A and 23B of the Federal Reserve Act. If any apparent violations are noted, they should be referred to the appropriate regulator.

The FBO's annual strength-of-support assessment also provides a basis for reviewing the branch's net due from/due to position. The strength-of-support assessment is an important factor to consider when the branch is in a net due from position. In developing these assessments, the U.S. banking supervisors make determinations about the financial strength of an FBO as well as the adequacy of home country supervision and the overall condition of the home country financial system. The strength-of-support assessment is considered when reviewing branches in a net due from position. (See the Strength-of-Support Assessment for Foreign Banking Organizations section of this manual for more guidance on this subject.) If necessary, the branch may be required to maintain a net due to related parties position or may be subjected to other prudential limitations, including asset maintenance requirements and growth restrictions.

From a supervisory viewpoint, a net due to position is regarded favorably because it provides a cushion for nonrelated depositors and creditors. A net due from position with related parties should be reviewed carefully. The review should consider any information on the underlying assets represented by a net due from related party account. For example, the due from head office account may be used to fund export financing from the home country with payment of the head office account scheduled to come from the receiving party.

In addition to providing funding to related entities, branches may also provide U.S. dollar clearing services. Such transactions would flow through the due from/due to accounts and would consist of checks and other clearing items denominated in U.S. dollars. The branch would, in turn, clear and process the items typically through its U.S. correspondent bank for payment.

The due from/due to accounts may also contain allocations for loan loss reserves and other

contingencies, which would normally flow through earnings and be deducted from capital in a stand-alone operation. Such allocations must be identified and fully explored by the examiners in order to ensure that the branch's financial risks are being covered.

The branch's current period profit and loss is included in the due from/due to subledger accounts with a due to a (credit) balance representing profit and a due from (debit) balance representing a loss. Accumulated but unremitted profit or accumulated but unreimbursed loss also may be included in this account. Note that this situation only applies to the profit and loss segment of the accounts. For example, a very profitable branch could have a net due from related parties position for reasons related to funding but the profit and loss subledger of this account should reveal a due to (profit) balance.

Due from/due to accounts are sometimes used to effect asset transfers from one office to another. Such transfers should be scrutinized and reconciled to ensure propriety. For example, problem loans may be transferred to head office, offshore, or other U.S. and non-U.S. branches. Such transfers should be revealed in the due from/due to accounts, and should be communicated to the examiner-in-charge.

A branch with an asset maintenance requirement will need to keep accurate daily records of the due from/due to related office positions in order to accurately track and report its adherence to the asset maintenance requirement to the regulators. The gross due from/due to related office positions are factored into the computation for the asset maintenance requirement. (See the Asset Maintenance section of this manual for more details on this subject.)

# Due From/Due To Related Offices

## Examination Objectives

Effective date July 1997

## Section 3240.2

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1. To determine if the policies, practices, procedures, and internal controls regarding due from/due to accounts are adequate.
2. To determine if branch officers are operating in conformance with the established guidelines from head office.
3. To evaluate the nature of all related accounts to determine character, volatility, level, flow of funds, and compliance with appropriate laws.
4. To determine the scope and adequacy of the audit function with respect to the branch's related parties position.
5. To evaluate the branch's net due from/due to position with related parties in relation to the FBO's strength-of-support assessment and the overall assessment of its combined U.S. operations.
6. To determine that all due from and due to accounts are reasonably and accurately reported.
7. To recommend corrective action when policies, practices, procedures, or internal controls are deficient or when violations of law or regulations have been noted.

# Due From/Due To Related Offices Examination Procedures

Effective date July 1997

## Section 3240.3

1. Determine the related parties position in accordance with the instructions to the Report of Assets and Liabilities.
2. Review the FFIEC 002 report and the appropriate due from/due to schedule and reconcile the figures to the general ledger to ensure accuracy.
3. Obtain a listing of any deficiencies noted in the latest review conducted by internal/external auditors with respect to the branch's related parties position, and determine if appropriate corrections have been made.
4. Review the branch prepared reconciliation of related party accounts, match the closing balances to the general ledger and the cut-off statement, and ensure that departmental controls over entries to the proper accounts within the general ledger are being followed, then:
  - a. Determine the reasonableness of any unusual items noted in the reconciliation.
  - b. Determine if any old open items have been charged off and, if so, were the charge-offs appropriate and within head office policy.
  - c. Determine if any large or unusual items are outstanding, and review related correspondence.
  - d. Determine if any overdrafts exist in related party accounts, and determine how these overdrafts are monitored and approved by head office. Share this information with the examiner evaluating loans.
  - e. Retain custody of all trial balances, only if necessary and practical.
5. For each account, determine the purpose (e.g., funding, lending, clearing, reserve allocation, etc.) and the level of volatility. Ensure that the purpose of the account is consistent with the balances and the volatility.
6. Identify what interest, if any, is paid and received on due from/due to accounts to determine if the rates are above or below market rates. Share this information with the examiner evaluating earnings.
7. For accounts that represent reserves, determine the precise nature of these reserves, identifying all activity since the previous examination. Share this information with the examiner-in-charge and the examiners in charge of loan administration and earnings, if applicable.
8. Determine if any transfers of loans have occurred between examinations. If so, review the entries and share this information with the examiner in charge of loan review.
9. Review the workpapers associated with the profit and loss accounts to ensure that reported earnings or losses are properly reflected in the due from/due to accounts with head office. Note whether provisions for general reserves are taken through earnings.
10. If the branch is in a net due from position, determine if it represents a concentration (greater than or equal to 25 percent) of the branch's net assets and assess the potential risks of such a concentration.
11. Identify any office on which the branch relies heavily for funding and share this information with the examiner reviewing liquidity.
12. If the branch is operating under a supervisory agreement that limits net due from positions or imposes an asset maintenance requirement, test check for accuracy of reporting to the regulators.
13. Update the workpapers with any information that will facilitate future examinations.

# Due From/Due To Related Offices Internal Control Questionnaire

Effective date July 1997

## Section 3240.4

Review the branch's controls, policies, practices, and procedures for obtaining and servicing loans, placements, deposits, and borrowed funds from related parties. The branch'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. Does the branch have in place a written policy approved by branch and head office management that:
  - a. Outlines the objectives of due from/due to related accounts?
  - b. Describes the branch's philosophy relative to funding and clearing needs, reserve policies, overdraft policies and approval limits, and proper recognition of profits and losses?
  - c. Provides a system of reporting requirements to monitor interoffice activity?
  - d. Provides for review and revision of established policy at least annually?
2. Does the branch maintain subsidiary records for each related office?
3. Is the preparation, addition, and posting of the subsidiary related accounts records performed or adequately reviewed by persons who do not also:
  - a. Handle cash, telex, or wire transfers?
  - b. Issue official checks and drafts?
  - c. Prepare all supporting documents required for payment of debt?
4. Are subsidiary related account records reconciled with the general ledger accounts at an interval consistent with interoffice activity and are the reconciling items investigated by persons, who do not also:
  - a. Handle cash, telex, or wire transfers?
  - b. Prepare general ledger entries.
  - c. Prepare or post to the related party's borrowed funds records?
5. Are interest computations, if any, checked by persons who do not have access to cash?
6. Do monthly reports furnished to the head office reflect the activity of related accounts, including amounts outstanding, overdrafts, interest rates, interest paid to date, and anticipated future activity?
7. 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.

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

In the event the branch is in a net due from position greater than or equal to 25 percent of net assets, conduct the following procedures.

9. Carefully review the FBO's strength-of-support assessment to determine whether any concerns exist with respect to its general ability to support its U.S. operations. If so, determine the extent to which the branch depends on head office or related parties for contingency funding, and any effect on the ability of the branch to meet third party obligations. Discuss any concerns with the examiner-in-charge for further guidance.
10. If the branch is in a net due from position greater than or equal to 25 percent of net assets with an affiliate located in a country other than its home country, determine:
  - a. If the affiliate is a financial institution that has been assigned a strength-of-support assessment or has received a rating by an independent agency.
  - b. If the affiliate is not a financial institution, discuss the nature and future of this funding relationship with branch management. Discuss any concerns with the examiner-in-charge.
11. Is the branch reconciling its accounts with related parties at an interval consistent with the interoffice activity, and is there a system to identify and monitor old items or large items?
12. Are extensions of credit being granted to or are loans being transferred to related parties? Are the credit extensions performing? At the time of transfer, were the assets performing?
13. Are the due from time deposits with related parties performing?
  - a. Are the placements continually renewed or is there actual payment at maturity?

- b. If the branch is providing funding to an offshore related financial institution, determine the purpose of the funding and its utilization.
- Is the entity well capitalized?
  - Are the funds used to lend to ICERC classified countries? Are these loans to finance trade transactions and are these loans performing?
  - Is the entity purchasing problem loans from the branch? If so, this relationship should be closely scrutinized because the branch may be funding the sale of its problem assets through the placement of funds with the purchasing entity.
14. Does the net due from related parties position represent a concentration of transfer risk to any one country that could have a significant impact on the repayment of the branch's third party liabilities?
15. If the branch is operating under an asset maintenance requirement, is it appropriately monitoring and accurately reporting due from/due to related office positions to the regulators in the asset maintenance computation?

# Due From/Due To Related Offices

## Audit Guidelines

Effective date July 1997

Section 3240.5

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1. Using an appropriate sampling technique, select items for review of supporting documentation, including terms, balances, and other appropriate details, and request a positive confirmation from the related office. Control all answered confirmations and investigate any reported differences. Include all confirmations in the workpapers and document the disposition of all exceptions or no-replies.
2. Examine supporting documents for accuracy and trace applicable entries, including proceeds, to detail records and to the general ledger.
3. Test check interest computations for accuracy and trace entries to appropriate accounts.
4. Examine transactions for consistency with the stated purpose of the related accounts.

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

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

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

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

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

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

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

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

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

Contingent liabilities containing primarily credit risk include the following categories:

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

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

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

## STANDBY LETTERS OF CREDIT

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

## COMMERCIAL AND SIMILAR LETTERS OF CREDIT

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

## PARTICIPATIONS IN ACCEPTANCES CONVEYED TO OTHERS BY THE SUBJECT BRANCH

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

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

## PARTICIPATIONS IN ACCEPTANCES ACQUIRED BY THE SUBJECT BRANCH

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

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

## FUTURES AND FORWARD CONTRACTS

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

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

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

### **STANDBY CONTRACTS AND OTHER OPTION ARRANGEMENTS**

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

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

### **FOREIGN EXCHANGE CONTRACTS**

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

### **INTEREST RATE SWAP CONTRACTS**

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

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

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

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

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

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

# Guarantees Issued

## Examination Objectives

Effective date July 1997

## Section 3310.2

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

# Guarantees Issued

## Examination Procedures

Effective date July 1997

## Section 3310.3

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

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

# Guarantees Issued

## Internal Control Questionnaire

Effective date July 1997

## Section 3310.4

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

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

### RECORDS

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

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

### CONCLUSION

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

# Guarantees Issued

## Audit Guidelines

Effective date July 1997

## Section 3310.5

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

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

### COMMERCIAL DOCUMENTARY LETTERS OF CREDIT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

## STANDBY LETTERS OF CREDIT

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

the credit is used in backing payment of commercial paper.

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

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

## GOVERNMENT AND AGENCY GUARANTEED LETTERS OF CREDIT

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

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

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

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

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

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

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

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

## ANTI-BOYCOTT REGULATIONS

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

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

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

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

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

# Letters of Credit

## Examination Objectives

Effective date July 1997

## Section 3320.2

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

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

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

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**POLICIES**

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

**RECORDS**

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

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

**COMMISSIONS**

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

**DOCUMENTATION**

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

**DEFERRED PAYMENT LETTERS OF CREDIT**

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

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

## STANDBY LETTERS OF CREDIT

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

## OTHER

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

confirmed and at frequent intervals thereafter?

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

## CONCLUSION

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

# Letters of Credit

## Audit Guidelines

Effective date July 1997

## Section 3320.5

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

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

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

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

### POLICIES, PROCEDURES AND LIMITS

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

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

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

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

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

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

### MANAGEMENT INFORMATION REPORTS

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

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

## OPERATIONAL CONTROLS

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

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

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

the attention of the appropriate operations manager.

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

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

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

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

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

Traditional ratio and peer earnings analyses are not relevant at a branch because earnings are largely influenced by the role of the branch within the foreign banking organization (FBO).

Some FBOs maintain a U.S. presence to meet certain global portfolio considerations. As a result, their U.S. operations may likely engage in a wide range of activities similar to those of U.S. domestic banks. Other FBOs may have different objectives in establishing a U.S. presence, such as to provide funding and clearing services. A branch may also benefit from unique relationships that have a positive effect on its earnings, such as interest free funds, advances from the head office or managing assets not reflected on its books. Therefore, earnings should be evaluated primarily against budgeted numbers, which should be based on the branch's strategic plan. The examiner should also determine the role that the earnings and revenue structure plays in the context of the overall U.S. operations and objectives of the FBO. Comments may be warranted as to the adequacy of such results.

In establishing the budget, management should assess the broad range of financial and operational risk exposures, which are encompassed in the strategic plan. Projections should take into account not only the composition, quality, and risk structure of branch assets but also the internal control environment under which the assets are booked. Further, management's ability to prepare realistic budgets and meet budgeted projections would indicate some measure of effective planning and control over the branch's activities. To maximize effectiveness, budget projections should be periodically reviewed and updated as conditions change throughout the fiscal year. Actual results should be periodically compared to budget and material variances identified and reviewed by management.

### GENERAL EXAMINATION APPROACH

Earnings are not a rated component of the branch rating system, although the level of earnings or absence of earnings may affect rating components. The review of earnings also

provides important information on the nature and efficiency of the branch's operations. The evaluation of earnings will consider, primarily, the effectiveness of a branch's comprehensive risk management procedures as it affects budgetary performance. Accordingly, variances to budgets should be reviewed. Persistent variances or exceptions may indicate poor planning or unrealistic projections, barring changes in economic and market conditions and other external factors or influences from the head office, which are beyond the branch's control.

The accuracy and integrity of earnings presented in risk management reports should be evaluated. For instance, reported earnings that do not properly reflect potential losses in the branch's credit risk exposures or accrued income on nonperforming loans may raise questions about the effectiveness of financial and accounting controls. The examiner should keep in mind, however, that the consolidated benefits derived by the FBO, as a result of maintaining a market presence to facilitate a global banking service network, may offset any earnings deficiencies or continued loss operations. Accordingly, the branch's strategic plan and function within the FBO and standards used by the head office to evaluate earnings performance must be ascertained and analyzed.

Examining the changes in earnings over time (a trend analysis) is a fundamental method for evaluating earnings. The trend in overall earnings and trends in earnings components should be reviewed to the extent that the branch's strategic plan has not changed significantly. Any significant changes or variances in profits or any of the components of income and expense should be investigated. Improving, deteriorating, and even flat earnings can be the result of not only changes in economic conditions but also of management's actions or influence over earnings through intrabank transactions. Some profitability ratios have been used, including net interest income/average assets (net interest margin) and net operating income/average assets, to make such an assessment. While providing a basis for analysis, particularly in year-to-year comparisons, earnings ratios can vary significantly among branches, depending on the nature of branch activity and the degree of support or influence exerted by head office.

## PROFIT CENTERS AND COST CENTERS

Generally, branches will function as profit centers or cost centers. As an independent profit center, a branch will likely have a broad earning asset base and could have substantial off-balance-sheet activities. The branch would likely offer a broad array of products and services. Thus, earning assets and fee-based services would be primary sources of income. Examiners should consider the income distribution and the relative profitability and stability of the various sources of income.

As a cost center, the branch would serve a more narrowly defined central purpose of either providing a service to the head office or the FBO's customer network, such as a provider of funds to other bank offices. As such, the branch would likely offer only a limited number of products or services. Earnings at such offices will generally be less than robust.

Accordingly, profitability as a factor in evaluating the branch is diminished. In these instances traditional ratio and trend analysis is not relevant and alternate analysis techniques should be employed. The examiner should determine the standards that head office management uses in evaluating the branch's performance. This analysis will focus on the branch's strategic plan or primary function, for example, to serve as a source of liquidity for the head office or other branches, to service the FBO's trade-related business or to give the FBO a presence in a particular geographic location as part of its global banking network.

## FACTORS AFFECTING EARNINGS

### The Mission of the Office

The level of earnings would generally be driven by the branch's mission. In this context, internal factors could significantly influence earnings to the extent that a branch's earnings are essentially managed by the head office. To make this determination, examiners should carefully evaluate reported income for unusually high or low profit margins. For example, a branch may have ancillary functions from which it incurs additional expense or receives supplementary income, such as managing an offshore book or providing management or technical services to other offices

in a regional office function. If the fees for these services are not directly related to or based on the fair value of goods and services received, the branch's earnings can be affected. Services could include electronic data processing, audit and credit review, credit management, and foreign exchange and correspondent banking services.

### Funding Sources

A branch that is funded through borrowings from related entities may have its cost of funds adjusted above or below market rates or even priced below the FBO's cost of funds. The head office might also provide an interest free capital allocation, or fund the branch's reserves at no cost. In these ways, the head office can either subsidize or reduce the branch's net interest income.

### Transfer of Assets

The FBO may also transfer assets to or from a branch's books, which also will affect earnings. The transfer of nonperforming and other problem loans from the branch to the head office or another branch of the FBO will improve a branch's earnings and, conversely, negatively affect the earnings of any branch designated by the FBO as a workout branch. Low quality loans maintained on a branch's books would reduce interest income to the extent that full interest payments are not received. The transfer of such assets from the books of a branch would improve the quality of its assets, support its net interest income, and reduce its need for loan loss provisions and charge-offs. High quality earning assets may also be transferred to a branch's books from the head office. This may occur with start-up offices or branches that cannot otherwise generate earning assets at a level to sustain operations and fund the cost of doing business.

### Accounting Considerations

Earnings at a branch may also be distorted to some extent because of the effect of home country accounting standards, administrative, tax, or other external influences. Accordingly, in reviewing earnings, the examiner should adjust branch income and expense statements to correspond with U.S. generally accepted accounting

principles. If statements cannot be adjusted, the examiner's written analysis must take into consideration major accounting aberrations. More commonly seen accounting exceptions may include:

- Recognizing interest income on loans, which, according to U.S. standards, should be placed on nonaccrual status.
- All U.S. offices of a foreign bank may be combined for income tax purposes; accordingly, taxes might be calculated by a regional office and the branch may not accrue for taxes.
- Failure to record unrecognized gains and losses on trading assets and certain off-balance sheet contracts in accordance with FASB 115 and FIN 39 can affect both asset valuations and earnings.

## ANALYTICAL REVIEW

### Interest Income

Recognizing that branch earnings are primarily evaluated against budgeted numbers, a comparison of detailed balances on a period-to-period basis also should be performed to assess trends in account balances. Such a review also would provide the examiner with an understanding of branch operations and help to identify potential problem situations. The analysis of net interest income will give an indication of management's ability to borrow at attractive rates and invest those funds with maximum profitable results. The level and trend of net interest income should be established and evaluated. As with any financial institution, the composition of net interest income should be reviewed for quality and stability.

In analyzing net interest income, the computation of net interest margin (interest income minus interest expense, divided by average earnings assets) is helpful, although the potential distortion of net interest income through interoffice transactions can limit the usefulness of the ratio. When discussing growth in earnings, the examiner should clearly differentiate between increases due to rates or yields versus volumes of earning assets. An improvement in net interest income, as a percentage of earning assets, may reflect favorably on management's ability to invest its funds at favorable yields or its ability to find less expensive sources of funds. However, it also may reflect changes in rates on

interoffice transactions. The management of interest rate risk also can affect earnings. An aggressive or speculative funding policy, whereby the branch is permitted to maintain large interest rate sensitivity gaps, could result in material increases or decreases in margins.

### Asset Yields

An analysis of asset yields should provide a measure of the branch's ability to invest funds in earning assets that provide a rate of return over the cost of funds. The analysis of asset yields and cost of funds should include whether market rates are paid for funds borrowed from the interbank markets and the level and cost of interoffice funding activities. If market rates of interest are not charged on interoffice borrowings or paid on interoffice placements, net interest income can be materially distorted. For example, if a branch is a net user of head office or interoffice funds, rates on intrabank borrowings could be adjusted upward or downward to increase or reduce the branch's cost of funds, which would flow through to net interest income. A branch that is a net provider of funds to the bank may be required to charge below market rates to other offices of the FBO. This situation would have an adverse affect on gross interest income and apply downward pressure to the net interest margin.

The level of nonperforming assets would also adversely affect net interest income. Nonperforming and renegotiated credits either provide no income or provide a reduced rate of income to the extent that the assets are no longer profitable relative to the cost of funds and the cost of doing business.

### Reserves

Regulatory agencies have long recognized that an allowance for loan loss reserves is only meaningful for the bank as a whole and not on a branch by branch basis. Accordingly, branches of FBOs are not required to establish separate loan loss reserves on the books of each branch, but may do so voluntarily, or to meet local requirements. Provisions for loan loss reserves may either be transferred to the branch from the head or regional office, or may be directly charged against the branch's earnings. However, unlike at stand-alone operations that are separately

capitalized, concerns arising from inadequate loan loss reserves are not key issues at a branch.

context of the examination report is not the same as defined in U.S. generally accepted accounting principles.

## Other Income and Expenses

Examiners should analyze the composition, level, and trend of other income and expenses. Non-interest income would include trading commissions and fees, deposit service charges, and letter of credit fees, among other items. Noninterest expense includes personnel and occupancy expense, and other operating expenses that arise from the normal activities of the branch. An analysis of these components would be especially valuable when evaluating a limited purpose branch or a branch that is suffering operating losses. Fees for intrabank services provided or received from related entities should also be reviewed. Earnings can be materially distorted if market rates are not charged for these services.

## Extraordinary Gains or Losses

Extraordinary gains or losses result from anything outside the normal operations of a branch and should be analyzed carefully for their effect on earnings. Generally, extraordinary gains or losses result from the sale or disposal of assets and because of accounting changes. Examiners should note that “extraordinary” as used in the

## Offshore Shell Branches

Earnings for offshore shell branches should be maintained separately from those of the U.S. branch. As such, report comments should be limited to the income and expenses of the U.S. branch. Earnings for the offshore branch are frequently commingled in the U.S. branch’s management reports. The U.S. branch may absorb the offshore shell branch’s indirect expenses, such as personnel expenses, without charging a fee. The significance of these indirect expenses varies depending upon the relationship of the U.S. branch to the offshore shell branch. However, because the allocation of these expenses are ultimately under the direction of head office management, exception should not be taken to this practice. Also, examiners, generally should not question the tax implication to the U.S. branch if the branch and the offshore shell branch file a combined federal income tax return. However, expenses between a branch and a related U.S. banking subsidiary of the foreign banking organization should be properly allocated and in accordance with applicable laws and regulations.

# Income and Expense

## Examination Objectives

Effective date July 1997

## Section 3400.2

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1. To review and understand the branch's strategic plan and mission within the FBO, specifically the earnings objectives.
2. To assess management's ability to prepare realistic earnings projections and the effectiveness of the overall budgeting program for monitoring and controlling income and expense.
3. To evaluate the reasonableness of performance targets given the branch's strategic plan and mission objectives, particularly with respect to budget variances.
4. To determine whether budgets are reasonable.
5. To determine to what extent earnings are affected by such factors as above or below market interoffice funding, interoffice transfers, and interoffice expense allocations.
6. To analyze the level of significant trends in income and expense, particularly in terms of the branch's strategic plan, and current economic conditions.
7. To determine and comment on whether income reported to the head office, under the FBO's accounting procedures, accurately reflect true earnings, when adjusted for head office subsidies and the charges related to likely future loan losses.
8. To evaluate the adequacy of financial and accounting controls relating to income and expense.
9. To evaluate the effect on earnings of any unusual and extraordinary gains or losses.
10. To recommend corrective action when policies, practices, procedures, or internal controls are deficient.

# Income And Expense

## Examination Procedures

Effective date July 1997

## Section 3400.3

1. Determine to what degree the branch is a profit center. If it is a profit center, calculate the net interest margin and review the trend. Consider the following:
  - a. To what degree does the agency raise its own funds and set its own cost of funds?
  - b. How is the pricing of loans and funds determined? Is it market driven or controlled by other factors?
  - c. Are transfer costs to affiliates reasonable, in relation to the services provided?
  - d. To what extent do transfer costs/benefits affect net earnings?
2. Determine if any significant changes have occurred in:
  - a. The branch's operations.
  - b. Accounting practices in U.S. or home country.
  - c. The branch's financial reporting.
  - d. General business conditions in U.S. or home country.
  - e. Tax codes in the U.S. or home country.
3. Obtain current financial statements, internal operating reports, interim financial statements, reports filed with the Federal Reserve, daily statements of assets and liabilities, and other available financial information. Look for the development or continuation of adverse trends and other significant or unusual trends or fluctuations. Primary considerations should include whether:
  - a. Significant structural changes are occurring in the branch that may affect the earnings stream.
  - b. The branch is making use of tax carry-backs or carryforwards.
  - c. Earnings are static or declining, as a percentage of total resources.
  - d. Income before securities gains and losses, is decreasing as a percentage of total revenues.
  - e. The ratio of operating expense to operating revenue is increasing.
  - f. Income and expense trends are inconsistent.
  - g. The spread between interest earned and interest paid is decreasing.
  - h. Loan losses are increasing.
  - i. Provisions for loan losses, if applicable, are sufficient to cover loan losses and whether overall reserves at an adequate level.
4. Obtain and review planning procedures, profit plans, budgets, mid-and long-range financial plans, economic advisory reports, and any related progress reports and:
  - a. Compare actual results to budgeted amounts.
  - b. Determine the impact of specific goals that have been set.
  - c. Determine the frequency of planning revisions.
  - d. Determine how planning revisions are triggered.
  - e. Determine who initiates plan revisions.
  - f. Determine whether explanations are required for significant variations and whether causes are ascertained to implement corrective action.
  - g. Determine the sources of input for forecasts, plans, and budgets.
5. Review ledger accounts for unusual entries. Examples of such items include:
  - a. Significant deviations from the normal amounts of recurring entries.
  - b. Unusual debit entries in income accounts or unusual credit entries in expense accounts.
  - c. Significant entries from an unusual source, such as a journal entry.
  - d. Significant entries in other income or other expense, which may indicate fees or service losses on an off-balance-sheet activity (i.e., financial advisory or underwriting services).
6. Investigate conditions of interest disclosed by the procedures in the preceding steps by:
  - a. Discussing exceptions or questionable findings with the examiner responsible for conducting those aspects of the examination that are most closely related to the item of interest to determine if a satisfactory explanation already has been obtained.
7. There is evidence that sources of interest and other revenues have changed since the prior examination.
8. There are any differences between branch accounting practices and U.S. regulatory accounting standards and generally accepted U.S. accounting principles.

- b. Reviewing copies of workpapers prepared by internal auditors or management that explain account fluctuations from prior periods or from budgeted amounts.
  - c. Discussing unresolved items with management.
  - d. Reviewing underlying supporting data and records, as necessary, to substantiate explanations advanced by management.
  - e. Performing any other procedures considered necessary to substantiate the authenticity of the explanations given.
  - f. Reaching a conclusion as to the reasonableness of any explanations offered by other examiners or management, and deciding whether extensions of examination or verification procedures are necessary.
7. Review with officers and prepare, in appropriate report format, listings of deficiencies in and deviations from policies, practices, procedures, internal controls, and adverse trends.
  8. Prepare a complete set of workpapers to support examiner conclusions and discuss all material findings with management.

Management information systems (MIS) should gather, interpret, and communicate information regarding the branch's business activities and their inherent risks. Accurate, informative, and timely MIS are essential to the prudent operation of any branch office. In fact, the examiner's assessment of the quality of the MIS is an important factor in the overall evaluation of the risk management process, which is discussed in the ROCA Rating System section of this manual.

In the evaluation of MIS, examiners should determine the extent to which the risk management function monitors and reports the branch's risk exposures to local and head office management.<sup>1</sup> Risk exposure levels and other significant measures such as profit and loss statements should be reported to managers who supervise but do not, themselves, have operational responsibilities in the area of activity. Frequent reports should be made as warranted by the activity and type of risk. Reports to head office management may occur less frequently, but examiners should determine whether the frequency of reporting is sufficient for head office to maintain proper oversight over the branch's activities.

The form and content of the MIS will relate to the branch's operations and organization, policies and procedures, and management reporting lines. Examiners will find that the form of branch management information systems will vary substantially with no particular structure shown to be optimum. MIS, however, generally take two forms: computing systems with business applications and management reporting. For branches with extensive lending or trading operations, a computerized system should be in place. For branches with more limited operations in terms of risk and size, an elaborate computerized system may not be cost effective.

Not all management information systems are fully integrated within the branch or within the FBO. Generally, this aspect should be evaluated based on the complexity and degree of risk in the branch's activities.

Examiners should expect to see varying degrees of manual intervention and should determine whether the integrity of the data is preserved through proper controls, which will factor into the overall assessment of the branch's

operational controls. The examiner should review and evaluate the sophistication and capability of the branch's computer systems and software, which should be capable of supporting, processing, and monitoring the branch's changing risk profile. Generally, in evaluating the individual branch management information system, the examiner should focus on its overall effectiveness in monitoring the branch's level of risk within established parameters rather than its form.

Other considerations in evaluating the MIS include:

- Whether reports are presented in a format that is easily read and understood by senior management;
- Whether the branch has personnel with sufficient expertise to maintain MIS;
- Whether reports are updated and customized to reflect changes in the business environment or management's requirements;
- Whether an adequate reconciliation procedure is in place to ensure the integrity of data inputs; and
- Whether the system is independently audited by internal and external personnel with sufficient expertise to perform a comprehensive review of management reporting, financial applications, and systems capacity.

Management reporting summarizes the branch's day-to-day operations, including risk exposure. Reports also serve to provide management with an overall view of business activity for strategic planning. Reporting may be conducted via telephone, computer, correspondence, meetings, periodic management reports, audits, and examination reports. Examiners should evaluate the reporting process to determine whether it is sufficiently comprehensive for sound decision-making both on a day-to-day level and for future planning. To the extent that problems in specific areas of the branch may relate to inaccurate or inadequate reporting, the examiner also should review results and comments from other areas of the examination.

If the branch has extensive reporting requirements, it is not necessary to review each report. Instead the examiner should summarize the monitoring process in each area, giving only such information as is needed to justify the evaluation.

1. FBOs with multiple U.S. offices may establish an intermediate or regional U.S. reporting line. Such a reporting line should be evaluated to ensure that proper oversight by head office management is achieved.

Formal management reports will usually be generated by control personnel within the branch, independent from line management. Where line managers have input, the senior managers should be well aware of potential weaknesses in the data provided. Risk reporting should be assessed and performed independently of line management to ensure objectivity and accuracy and

to prevent manipulation or fraud. For branches operating in a less automated environment, report preparation should be evaluated in terms of timeliness and data accuracy. Cross checking and sign off by the report preparer and reviewer with appropriate authority promote a proper operational controls environment.

# Management Information Systems

## Examination Objectives

Effective date July 1997

Section 3410.2

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### RISK MANAGEMENT

1. To determine if the policies, practices, procedures, and internal controls regarding MIS are adequate.
2. To determine that risk management reporting summarizes the quantifiable and non-quantifiable risks of the branch to all appropriate management levels both at the local office and at the head office in a timely manner to ensure compliance with established risk parameters.
3. To determine whether management reporting provides adequate information for strategic planning to the extent conducted by local branch management.
4. To evaluate computer systems, communication networks, and software applications in terms of their ability to support and control the branch's activities.
5. To determine that the functions of automated systems and reporting processes are well understood by staff and are fully documented.

### OPERATIONAL CONTROLS

6. To determine the scope and adequacy of the audit function for MIS and management reporting.
7. To verify that only authorized users have access to automated systems.
8. To determine that the software applications relating to risk reporting, pricing, and other applications are fully documented and subject to independent review.
9. To determine that the automated systems and manual processes are designed with sufficient audit trails to evaluate and ensure data integrity.

### OTHER

10. To recommend corrective action when MIS policies, practices, procedures, or internal controls are deficient.

These procedures represent a comprehensive list of processes and activities to be reviewed during a full scope examination. The examiner-in-charge will establish the general scope of the examination and work with the examination staff to tailor specific areas for review as circumstances warrant. The procedures selected will be based on internal audit comments, previous examination workpapers, a general review of the activity to be examined, and the judgement of the examiner and examiner-in-charge.

### RISK MANAGEMENT

1. Obtain a flowchart of management reports and system flows, and review information to identify important risk points.
2. Review the policies and procedures for MIS and management reporting, including the scope, quality, and frequency of management reports. Determine whether head office management is receiving adequate and timely information to effectively monitor branch operations.
3. Review the functional applications such as credit administration, risk monitoring, liquidity and funds management, trade settlement, accounting, revaluation, etc., to determine the combination of automation and manual intervention for management reporting. Compare findings with examiners reviewing specific products or business lines.
4. Determine whether the range of risk management reports is adequately documented in terms of inputs (data bases, data feeds external to the branch, economic and market assumptions), computational features, and outputs (report formats, definitions). Evaluate the documentation for thoroughness and comprehensiveness.
5. Determine whether the range of reports (risk management, past due and nonperforming loans, financial performance, and operational controls) provides valid results to evaluate business activities and for strategic planning.
6. Comment on the branch's automated communications with the head office and/or U.S. regional management, if applicable. Can branch data be accessed directly by them?
7. Review lists of ongoing or planned information systems projects. Determine whether the priority of projects is justified given branch management's strategic goals and the recent mix of business activity.
8. Review, for frequency, the branch manager's attendance at periodic meetings with head office to report on branch activities.

### OPERATIONAL CONTROLS

9. Obtain copies of internal and external audits for MIS and management reporting. Review findings and management's responses to determine whether appropriate corrective action is taken by management.
10. Obtain an overview of the system's functional features with the financial institution's systems administrator. Browse the system with the administrator. Determine whether passwords are used and access to the automated system is restricted to approved users.
11. If the branch has a number of independent data bases for credit administration, risk monitoring, etc., determine the types of reconciliations performed, the frequency of data base reconciliation, and the tolerance for variance. Generally, independent data bases have more potential for data error.
12. Determine the usage of financial applications on terminals that are not part of the mainframe, minicomputer, or local area network. For example, traders may use their own written spreadsheet to monitor risk exposure or for reconciliation.
13. Determine whether the processing and production of reports is segregated from line management and staff. Where line management has influence, how does the branch validate summary data and findings?

### OTHER

14. Ensure that the branch has considered the impact of the century date change (year 2000) on its computer systems, and has

taken steps to correct any problems. Determine the extent of management's:

- a. awareness and due diligence
- b. risk assessment
- c. solution implementation and testing
- d. contingency planning

15. Recommend corrective action when policies, practices, procedures, internal controls or MIS are deficient.

# Management Information Systems

## Internal Control Questionnaire

Effective date July 1997

Section 3410.4

### RISK MANAGEMENT

1. Is management reporting adequate for the volume and complexity of the branch's range of activities? Are reports complete? Do they have clear formats? Are exceptions highlighted?
2. Does local and head office management have adequate information to monitor the changing risk profile of the branch? Does the branch have written policies regarding the type and frequency of reports to be submitted to a regional or head office level? Do the reports accurately convey the condition of the branch and the information required in accordance with written policies? How often does branch management communicate with its regional and head offices on an informal basis?
3. Is the risk measurement and management system sufficiently flexible to stress test the range of portfolios managed by the branch? Does the system provide usable and accurate output? If the branch does not perform automated stress testing, what process is used to minimize quantifiable risks in adverse markets?
4. Do reports provide information on the branch's activities that is adequate for sound planning? Are profitable and unprofitable activities clearly identified?
5. Do reports segregate positions by legal entity when appropriate?
6. Do policies and procedures address the range of system development and technical maintenance at the branch, including the use of outside vendors and consultants? Does the branch or FBO have a comprehensive computer policy? If the branch uses personal computers, there should be a written policy to address access, development, maintenance, and other relevant issues.
7. Are there functional specifications for the system? Are they adequate for the current range of automated systems at the branch? Do they address both automated and manual input and intervention?
8. Does the branch have flowcharts or narratives that indicate the data flow from input through reporting? Is this information comprehensive for the level of reporting necessary for the branch?
9. Are third party vendors provided with adequate lead time to make changes to existing programs? Is sufficient testing performed before system upgrades are implemented?
10. Are planned enhancements or development projects given appropriate priority based on management's stated goals?
11. Does the system design account for the different pricing conventions and accrual methods across the range of products in use at the branch? Evaluate the range of system limitations for processing and valuation across the range of products utilized by the branch. Assess the possible impact on accuracy of management reporting.

### OPERATIONAL CONTROLS

12. Is management reporting prepared on a sufficiently independent basis from line management? Are appropriate segregation of duties in place for report preparation? Is the data accurate?
13. Is the scope of the audit coverage comprehensive? Are audits for MIS and reporting available? Are findings discussed with management? Has management implemented corrective action for deficiencies in a timely manner?
14. Is access to the automated systems adequately protected?
  - a. Do access rights, passwords, and logon IDs protect key data bases from corruption?
  - b. Are "write or edit" commands restricted to a limited set of individuals?
  - c. Are specific functions assigned to a limited set of individuals? Are access rights reviewed periodically?
  - d. Does the system have an audit report for monitoring user access?
  - e. Is access logon information stored in records for audit trail support?
15. Is management information provided from mainframe, minicomputers, local area networks, a single user personal computer, or a combination of the above?

16. Identify the key data bases used for the range of management reports.
- Are direct electronic feeds from external services, such as Reuters, Telerate, and Bloomberg employed? How are incomplete data feeds identified? Can market data be overridden by users? How does the branch ensure the data integrity of data feeds or manually input rates, yields, or prices from market sources?
  - Are standard instructions set within the automated systems? Can these be overridden? Under what circumstances?
  - For merging and combining data bases, how does the branch ensure accurate output?
  - What periodic reconciliations are performed to ensure data integrity? Are reconciliation personnel sufficiently familiar with the information to identify "contaminated" data?
17. Is the branch's computer system capable of handling year 2000 calculations?

## CONCLUSION

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

### 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. Such accounts often may be quite insignificant to the overall size of the branch. However, significant subquality assets may be discovered in accounts of some branches lacking proper internal controls and procedures.

#### Types of Accounts

Types of other assets frequently found in branches include the various temporary holding accounts such as suspense, 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 appropriate account. Branches will also have more permanent accounts recorded in other assets such as premises and furniture, leasehold improvements, purchased computer software, and deferred payment letters of credit. Nothing should be allowed to remain in the temporary holding accounts (“difference accounts”) for any significant length of time, usually no more than a few business days. Branches should have written procedures to ensure that difference accounts are reconciled and closed out on a timely basis. In any event, all difference accounts should be closed out at least monthly.

General categories of other assets common to branches on the accrual system are prepaid expenses and income earned not collected. Prepaid expenses represent cash outlay for goods and services, the benefits of which will be realized in future periods. Income earned and not collected results from the differences between accrual and cash-basis accounting.

There are an unlimited number of account titles that could be included in the other assets category, from bond coupons to art objects, antiques, and coin and bullion. 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.

#### Scope of other assets review

Examiners assigned to review other assets must obtain a detailed breakdown of such accounts, with a description of each account and the date each item was posted. Certain accounts, such as Other Real Estate Owned, may be reviewed by examiners assigned to other areas of the branch. Refer to Section 3090 for information on other real estate owned. 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 is materiality; however, even accounts with small balances may require attention. Net balance accounts must be grossed up. The examiner should then evaluate whether to analyze the nature and quality of each individual item based upon its impact on the overall soundness or risk standing of the branch. In this regard, it is important that the examiner verify the existence of the asset, the proper valuation of the asset, the adequacy of the accounting and disposition controls, and the quality of the asset.

An examiner should verify the existence of the assets selected by ensuring adequate supporting documentation. The examiner should also verify that ownership of the asset rests with the branch. The date the asset was acquired or first posted also is important. Temporary accounts such as suspense, should be cleared of stale items.

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 should ensure that the book balance of key personnel life insurance policies owned by the branch value the surrender charge, if any.

The examiner should assess the quality of the asset. Refer to Section 6010.1, Asset Quality Classifications, for information on the classification of assets.

The examiner should ensure that the controls concerning other assets protect the branch's ownership rights, that the accounts are properly valued and accurately reported, and that activity is monitored regularly by management. A branch with good controls 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 determine that posting errors and/or the common practice of netting certain accounts against each other do not cause significant balances to go unnoticed because of the lack of proper detail.

## OTHER LIABILITIES

"Other liabilities," as used in this section, include all balance sheet liability accounts not covered in other specific liability categories or in other areas of the examination. The accounts often may be quite insignificant to the overall size of a branch. In some branches, specific 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.

### Types of Accounts

A general category of other liabilities common to branches using accrual systems 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. The accounts include items such as interest on deposits, taxes, and expenses incurred in the normal course of business. There should be a correlation between the amount being accrued on a daily or monthly basis and the amount due on the stated or anticipated payment date.

The examiner should review other liability accounts to determine that accounts, such as deferred taxes (credit balance), are being prop-

erly recognized. This review should also determine that matters, such as pending tax litigation, equipment contracts, and accounts payable, have been recorded properly and are being discharged in accordance with their terms and requirements.

Various miscellaneous liabilities may be found within the accounts, such as deferred credits, suspense, and other titles denoting pending status. The number of possible items that could be included are unlimited and the accounts should be reviewed to 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.

### Scope of other liabilities review

Examiners assigned to review other liabilities are responsible for obtaining the branch's breakdown of those accounts and determining when they are to be reviewed under other sections of this manual. They must ensure that examiners in charge of those other sections receive the necessary information. The remaining accounts should be reviewed and evaluated by examiners assigned to this section.

The major emphasis in examining this area should be on the adequacy of the controls and procedures employed by the branch in promptly recording the proper amount of liability. Without proper management attention, these accounts may be misstated, either advertently or inadvertently. For instance, fraudulent entries in suspense or interbranch accounts could be rolled over every other day to avoid stale dates causing shortages to be effectively concealed for indefinite periods of time.

Like other assets, other liability accounts with small balances may be significant and net balance accounts should be grossed up. Scanning account balances may disclose a recorded liability but it does not aid in determining whether liability figures are accurate. Therefore, it is important to review information obtained from branch counsel handling litigation because these documents might reveal a major understatement of liabilities. Determining accurate balances in other liability accounts requires an in-depth review of source documents or other accounts from which the liability arose.

# Other Assets and Other Liabilities

## Examination Objectives

Effective date July 1997

## Section 3420.2

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1. To determine if policies, practices, procedures, and internal controls regarding other assets and other liabilities are adequate.
2. To determine that branch officers and employees are operating in conformance with established guidelines.
3. To evaluate the validity and quality of all other assets.
4. To determine that other liabilities are properly recorded.
5. To evaluate the scope and adequacy of the audit function.
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 or regulations have been noted.

# Other Assets and Other Liabilities

## Examination Procedures

Effective date July 1997

## Section 3420.3

1. Complete or update the Internal Control Questionnaire, if selected for implementation.
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 by internal/external auditors from the examiner assigned to Internal and External Audits, and determine if appropriate corrections have been made.
4. Obtain a trial balance of other asset and other liability accounts and:
  - a. Verify or reconcile balances to departmental controls and general ledger.
  - b. Review reconciling items for reasonableness.
5. Scan the trial balances for:
  - a. Obvious misclassifications of accounts and, if any are noted, discuss reclassification with appropriate branch personnel and furnish a list to appropriate examining personnel.
  - b. Large, old, or unusual items and, if any are noted, perform additional procedures as deemed appropriate being certain to appraise the quality of other assets.
  - c. Other asset items that represent advances to related organizations, officers, employees or their interests, and, if any are noted inform the examiner assigned to Credit Risk Management.
6. Determine that amortizing other asset accounts are being amortized over a reasonable period relative to their economic life.
7. If the branch has outstanding customer liabilities under deferred payment letters of credit, obtain and forward a list of names and amounts to the examiner assigned to Credit Risk Management.
8. Review the balance of any other liabilities owed to officers or their interests and investigate, by examining applicable supporting documentation, whether they have been used to record unjustified amounts or amounts for items unrelated to branch operations.
9. Develop and note in the workpapers any special programs considered necessary to properly analyze any remaining other assets or other liabilities account.
10. Test for compliance with applicable federal and state laws and regulations.
11. For other asset items that are determined to be stale, abandoned, uncollectible, or carried in excess of estimated values and for other liability items that are determined to be improperly stated, request management to make the appropriate entries on the branch's books after consulting with the examiner-in-charge.
12. Prepare in appropriate report form and discuss with appropriate officer(s):
  - a. Violations of laws and regulations.
  - b. Criticized other assets.
  - c. The adequacy of written policies relating to other assets and other liabilities.
  - d. Recommended corrective action when policies, practices, or procedures are deficient.
13. Update the workpapers with any information that will facilitate future examinations.

# Other Assets and Other Liabilities

## Internal Control Questionnaire

Effective date July 1997

## Section 3420.4

Review the branch's internal controls, policies, practices, and procedures concerning other assets and other liabilities. The branch's systems should be documented in a complete and concise manner and should include, where appropriate, narrative descriptions, flow charts, copies of forms used, and other pertinent information.

1. Has the branch formulated written policies and procedures governing both other asset and other liability accounts?
2. Does the branch maintain subsidiary records and supporting documentation of items comprising other assets and other liabilities?
3. Is the preparation of entries and posting of subsidiary other asset and other liability records performed or tested by persons who do not also have direct control, either physical or accounting, of the supporting data or related assets?
4. Are the subsidiary records balanced at least monthly to the appropriate general ledger accounts by persons who do not also have direct control, either physical or accounting, of the supporting data or related assets?
5. Are the items included in suspense accounts aged and regularly reviewed for propriety by responsible personnel?
6. Are receivables reviewed at least monthly for collectibility by someone other than the originator of the entry?
7. Is approval required to pay credit balances in receivable accounts?
8. Do credit entries to receivables accounts, other than payments, require the approval of an officer independent of the entry preparation?
9. Does charge off of a nonamortizing other asset initiate review of the item by a person not connected with entry authorization or posting?
10. Are invoices and bills proved for accuracy, prior to payment? Who has the authority to pay the invoices and up to what amount?
11. Are all payroll tax liabilities verified to appropriate tax returns and reviewed by an officer to ensure accuracy?

### CONCLUSION

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

# Other Assets and Other Liabilities

## Audit Guidelines

Effective date July 1997

## Section 3420.5

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1. Obtain or prepare detailed lists of other assets and other liabilities, including a breakdown of subsidiary ledgers.
2. Within each category of other assets, use an appropriate sampling technique to select specific items and:
  - a. Where appropriate, verify the original balance of the item from an invoice or other supporting document.
  - b. Examine documentation for additions to any given item since the previous audit.
  - c. Where amortization is applied to a given item, review the computations for the period since the previous audit to determine mathematical accuracy and the reasonableness of estimated life.
  - d. Determine the reasonableness of the current balance by reviewing the remaining estimated life, collectibility, etc.
  - e. Prepare any special programs considered necessary to properly analyze and test specific accounts.
3. Determine that interbranch and affiliate transactions clear in the normal course of business by actually reviewing the entries to the account for several days and examining the debit and credit tickets. Special attention should be given to entry dates, authorizing initials, and validity or reasonableness of the item.
4. If a branch is on an accrual basis of accounting:
  - a. Review the branch's system of recording liabilities for interest, taxes, and other expenses.
  - b. Review the balance of interest accrued to outstanding interest-bearing liabilities for reasonableness.
  - c. Review the balance of the reserve for both current and deferred taxes for reasonableness by examining the worksheets and computations.
  - d. Review the reasonableness and completeness of the balance reflected for reserves for other expenses.
5. Within each general category of other liabilities, use an appropriate sampling technique to select specific items for further review. For each item selected, determine that the balance is reasonably stated by examining supporting documentation.
6. Review accounts not sampled, for items that appear unusual in nature or amount and examine supporting documentation.
7. Using an appropriate sampling technique, select expense checks issued since the examination date and:
  - a. Determine whether the expense was incurred before or after the examination date by examining the vendor's invoice or other supporting documentation.
  - b. For expenses incurred prior to the examination, trace the amount to the detail list of other liabilities.
  - c. Discuss with appropriate branch officials, any significant items incurred prior to and recorded after the examination date.

This section describes the activities of private banking services and provides insight into adequate safeguards. The portions concerning hold mail, dormant accounts, and overdrafts are also applicable to the Deposit Accounts section of this manual because they can affect all types of accounts and account holders.

Private banking departments may offer a wide array of products and services to their clients, including, but not limited to, trust services (by referral to or in association with an affiliated trust entity), investment advisory services, foreign exchange trading, lending, letters of credit, bill paying, credit cards, and deposit services. Private banking generally markets its services to high net worth individuals and, if the client has a business, may entice them to develop a corporate banking relationship. Private banking accounts may be opened in the name of an individual, a commercial business, a trust, or a private investment corporation (PIC) registered in offshore havens.

The relationship between the private banker and the client is carefully cultivated by the banker; therefore, it is common for clients to follow private bankers to different financial institutions because of the level of trust that has been developed. As a result, private banking clients may delegate a significant amount of discretionary financial authority to private bankers. Some private banking departments have small staffs that make the segregation of duties normally found in banking activities difficult to maintain. This combination of trust in the private banker and difficulty in segregating duties exposes private banking activities to possible account manipulation. As a result, the private banking area must have compensating internal controls to ensure proper supervision and safeguarding of client accounts.

Examiners should understand the nature and scope of the private banking activities. Additionally, examiners should carefully evaluate the policies, procedures, internal controls, credit reviews, and audits surrounding private banking to ensure that internal controls exist to detect fraud and prevent losses to both the branch and/or customers. Internal and external audits should provide an excellent source of information concerning the adequacy of policies, procedures and controls of private banking. The lack of an internal audit of the private banking

department should be viewed as a serious weakness and criticized in the examination report.

### REVIEW OF DEPOSIT ACCOUNTS AND REVIEW OF ACCOUNT DOCUMENTATION

Private banks often assist clients in forming shell corporations of PICs. PICs are generally incorporated in bank secrecy (tax haven) countries such as the Cayman Islands, Bahamas, British Virgin Islands, and Netherlands Antilles to maintain the clients' confidentiality, and/or for tax or trust related reasons. The beneficial owners of the shell corporations are typically foreign residents.

Reviewing the list of accounts for private banking clients may provide insight into some of the activities conducted by private banking. For instance, the review may reveal that the branch allows accounts that disguise the true identity of the client through the use of fictitious or code name accounts, accounts in the name of a PIC, or blind/numbered trust accounts. Management must be able to provide documented files on the identity of the ultimate account holder and details on the account relationship. Examiners should carefully scrutinize the reasons for these types of accounts and ensure that they do not compromise the institution's compliance with the Financial Recordkeeping and Reporting regulations, and the Federal Reserve's "Know Your Customer" guidelines.

Reviewing account documentation should reveal that the branch has an adequate quality control program in place for opening accounts that includes a follow-up system for obtaining missing or date-sensitive documents. Additionally, account documentation reviews should show how the branch documents its client relationships and implements its "Know Your Customer" policy.

An integral part of an effective "Know Your Customer" policy is a comprehensive knowledge of both the customer and the types of transactions carried out by the customer. As a general rule, a financial institution should never establish a business relationship until the identity of a potential customer is satisfactorily verified. Accordingly, the "Know Your Customer" policy should clearly identify the type of documentation needed before a relationship can

be formerly established. If a potential customer refuses to produce any of the requested information, the relationship should not be established. Likewise, if requested follow-up information is not forthcoming, any relationship already begun should be terminated.

The purpose of the business relationship should also be identified. Incoming client funds may be used for various purposes such as establishing deposits, funding investments, securitizing loans, paying bills, or establishing PICs or trusts. The “Know Your Customer” procedures established by the institution allow for the collection of sufficient information to develop a “transaction profile” for each customer. The primary objective of such procedures is to enable the institution to predict with relative certainty the types of transactions in which a customer is likely to engage. Internal systems should then be developed for monitoring transactions which are inconsistent with the customer’s transaction profile. The level, detail and documentation of “Know Your Customer” information should be greater for customers with larger balances and transaction volumes. (Examiners may refer to the Federal Reserve’s Bank Secrecy Act Manual and other similar examination material for more information).

## HOLD MAIL

Private banking clients and in particular, international private banking clients, are often provided hold mail service. Hold mail clients elect to have bank statements and other documents maintained at the institution rather than mailed to their home address. In most cases, this service is provided because the client’s country of residence has an unreliable or limited postal system or for security reasons. Controls over hold mail accounts should be carefully reviewed because the clients do not receive their statements promptly, and therefore, relinquished their ability to detect unauthorized transactions in a timely manner. One of the key controls that should be part of any hold mail operation is to have a process for ensuring that the back office receives customer account statements.

## DORMANT ACCOUNTS

Accounts that are inactive for a prolonged period of time could be subject to manipulation and

abuse by branch personnel. Examiners should carefully review the policies, procedures, and controls over dormant accounts. Effective controls over dormant accounts should include:

- A specified period of time between the last customer-originated activity and its classification as dormant.
- Segregation of signature cards for dormant accounts.
- Blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management outside of private banking.

## OVERDRAFTS/EXTENSIONS OF CREDIT

Private banking clients often pledge their assets, including cash, mortgages, marketable securities, land, and/or buildings to securitize loans. Loan proceeds are used for a variety of purposes, including, but not limited to, recapitalizing the client’s business(s) or providing working capital. Branch management should demonstrate understanding of each specialty business and should know what would affect the value of any collateral or business being financed. Loans to private banking clients may not be of sufficient size to be covered during the review of asset quality. However, it is important to ensure that a sampling of private banking loans and contingent liabilities are reviewed. In many instances, loans and other credit-related activities for private banking clients are collateralized by cash or marketable securities; therefore, credit underwriting standards and procedures may not be as complete or stringent as prudent banking practice would dictate.

Loans backed by cash or negotiable collateral are common in private banking. An extension of credit based solely on collateral, even if the collateral is cash, does not guarantee repayment. There are at least three ways in which a branch can lose its collateral: forfeiture through the seizure of assets by a government agency; theft or manipulation by a dishonest employee; and errors such as the inadvertent release of collateral by an employee. While the collateral enhances the branch’s position, it should not be used as a substitute for regular credit analyses and prudent lending practices unless the branch makes a separate determination of the

creditworthiness of the client. A client may be considered creditworthy if the branch performs its due diligence by adequately documenting that its client's funds were derived from legitimate means and can verify that the use of the loan proceeds are for legitimate purposes.

Examiners should ensure that policies and procedures for extending credit to private banking clients are in place and are being followed. The branch's credit review function should also sample private banking loans and ensure compliance with established policies. Loan files should contain sufficient information to assess the quality of the credit, the proper approvals, and the purpose and source of repayment. During the review of private banking loans, examiners should ensure that loan files include documented background information on the client's source of wealth and occupation, the purpose of the loan, and the source of repayment (other than collateral). Ambiguous purposes such as personal investments or working capital, and liquidation of cash collateral for source of repayment, are generally not acceptable. Weaknesses in this area could result in noncompliance with the Financial Recordkeeping and Reporting regulations (See the Federal Reserve's Bank Secrecy Act Manual and other similar examination material for details).

Loans secured by cash or marketable securities should have files containing pledge/assignment documents, which serve to perfect the branch's security interest. In addition, procedures should be implemented to monitor and document the value of the collateral. Documentary exceptions should be listed as technical exceptions.

Documented financial statements that support credit decisions and guarantees may be present. Financial statements should never be waived merely because the loan is secured by cash or marketable securities.

## BILL PAYING SERVICES

Private banking departments often provide bill paying services for their clients. If this service is provided, examiners should ensure that an agreement between the customer and the client exists for this service and that it has been reviewed by legal counsel. Typically, a client might request that the branch debit a deposit account for credit card bills, utilities, rent, mortgage payments, or

other monthly consumer charges. Policies, procedures, and controls over this area should be reviewed to ensure that they are adequate and protect the customer and the branch from fraud or abuse.

## SALE OF NON-DEPOSIT INVESTMENT PRODUCTS

Private banking departments are increasingly offering investment products to their clients under discretionary or nondiscretionary arrangements. In addition, private banking departments may also offer treasury services, portfolio management, financial planning advice and offshore services.

Although fiduciary and agency activities are circumscribed by formal trust laws, clients may delegate varying degrees of authority (discretionary versus nondiscretionary) over assets under management to the institution. In all cases, the terms under which the assets are managed are fully described in a formal agreement, also known as the "governing instrument", between the customer and the institution. The agreement should address the duties that a fiduciary is obliged to perform for its beneficiaries or customers, keeping the assets of the customers separate and distinct from those of the branch, and avoiding any circumstances that may conflict with the branch's fiduciary obligations. A client's portfolio may consist of a mixture of instruments bearing varying degrees of market and credit risk which should be appropriate to the client. Assets under management may include deposits, securities, loans, items held in safekeeping, and other products.

Examiners should determine, through discussions with private banking personnel, the types of products being offered to clients. Clients may be offered a wide range of products. Examiners should also determine the level of discretionary authority delegated to private banking personnel in the management of these activities and the documentation required from customers to execute transactions on their behalf. Private banking personnel should not be able to execute transactions on behalf of their clients without proper documentation from clients or independent verification of client instructions.

On February 16, 1994, federal and thrift regulatory agencies released a joint statement on

retail sales of mutual fund and other non-deposit investment products by federally insured institutions. It reaffirms the agencies belief that retail customers must be fully informed about risks associated with non-deposit investment products. Branches recommending or selling such products should ensure that customers are fully informed that the products: (1) are not FDIC-insured; (2) are not deposits or other obligations of the institution and are not guaranteed by the institution; and (3) involve investment risks, including possible loss of principal. Examiners should refer to this statement for further guidance. While this statement addresses insured

branches, the premises in this statement are applicable to uninsured branches.

Examiners should ensure that the branch has agreements with customers covering the terms of any asset management or other services provided, and that the agreements are on file. An evaluation of private banking personnel's ability and competence to provide the services offered should also be assessed. If the branch executes transactions or performs back-office functions, the examiner should refer to the Securities Activities section of this manual for further guidance.

# Private Banking

## Examination Objectives

Effective date July 1997

## Section 3430.2

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1. To determine if policies, practices, procedures, and internal controls covering private banking activities are adequate and are being followed by branch personnel.
2. To determine the scope and adequacy of the audit function.
3. To recommend corrective action when policies, procedures, practices, or internal controls are deficient or when violations of laws or regulations have been noted.

# Private Banking

## Examination Procedures

Effective date July 1997

## Section 3430.3

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The examiner should refer to the sections of this manual listed below as well as other applicable supervisory agency manuals for further information on examination procedures:

- Deposit Accounts section for examination procedures covering deposit accounts, hold mail, dormant accounts and overdrafts.
- Credit Risk Management section for examination procedures for extensions of credit.
- Federal Reserve's Bank Secrecy Act Manual or other similar examination material for examination procedures to check private banking activities for compliance with the Financial Recordkeeping and Reporting regulations.

The various state and federal agencies may differ in terms of specific practices and methodologies used to implement the following guidelines. For further guidance in this area, examiners should consult with their respective agencies.

1. If selected for implementation, complete or update the internal control questionnaire.
2. Review policies and procedural manuals, and internal control activities to determine their adequacy.
3. Assess the adequacy of the internal audit function as it relates to private banking.
4. Determine, through a discussion with management, what types of products are offered to private banking clients.
5. Review the agreements covering the products offered by private banking to determine that they adequately protect the branch and the customer.
6. Assess private banking personnel's level of competency to provide the services being offered to clients, i.e., education, experience, licenses, and the branch's training program.

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## POLICIES AND PROCEDURES

1. Does the branch have up-to-date policies and procedures regarding private banking activities?
2. Do the policies and procedures cover the following:
  - a. Definition of the products offered.
  - b. Client account opening procedures.
  - c. Client background checking procedures.
  - d. Account monitoring procedures.
  - e. Token name account requirements.
  - f. Account officer's responsibilities.
  - g. Documentation requirements.
  - h. Segregation of duties.

## OFFICE OF FOREIGN ASSETS CONTROL AND REGULATION

3. Are private banking customers reviewed against the Office of Foreign Assets Control and Regulation's (OFAC) listing of blocked accounts of foreign individuals and countries? (Refer to the Other Compliance Matters section of this manual for more information on OFAC).

## TOKEN NAMES

4. Does the branch maintain a listing of all token name accounts and is there sufficient documentation to ascertain the customer's "true" identity?
5. Does management periodically review all accounts?
6. Are there agreements on file that adequately outline the branch's powers and limits of liability?

## MANAGEMENT INFORMATION SYSTEMS

7. Are complete and accurate management reports received by private banking administrators and senior management on a timely basis?

8. Do the management reports cover the following:
  - a. Credit.
  - b. Overdrafts.
  - c. Cash and deposit activity.
  - d. Limit exceptions.
  - e. Past-due accounts.
  - f. Missing documents.
  - g. Daily activity.
  - h. Off-balance-sheet exposure (e.g., letters of credit).
  - i. Sale of non-deposit investment products.

## AUDIT COVERAGE

9. Does the audit report provide management with an adequate appraisal of the private banking function?
10. Does the audit report cover all of the necessary control concerns and procedures listed in this internal control questionnaire?
11. Do management responses indicate that prompt and appropriate corrective action is taken when exceptions are noted?

## DEPOSIT ACCOUNTS

Refer to the Deposit Accounts section of this manual when reviewing deposit account activities managed by the private banking staff.

## HOLD MAIL

12. Does the branch have a "hold harmless" statement for hold mail accounts? Are hold mail accounts tested to ensure hold harmless statements are on file and are signed by customers?
13. Are hold mail statements kept in a secured area and segregated from the private banking area?
14. How is hold mail released to customers? (It should not be given to private bankers to deliver to the customer).
15. Are customers required to sign a form acknowledging receipt of their hold mail? Is the signature verified against signature

cards? Does the form list what mail was received?

16. What items are kept in hold mail files?
17. Are hold mail customers required to pickup hold mail within a specified period? What procedures are followed if hold mail is not picked up within specified periods?
18. Does an adequate audit trail exist in the hold mail area?
19. Does the internal audit function adequately review the hold mail function?

Refer to the Deposit Account section of this manual for more questions.

## DORMANT ACCOUNTS

20. Over what time period does an account become dormant? Are dormant accounts blocked on the computer system or are all transactions on dormant accounts reviewed for authenticity?
21. If the appropriate time defining a dormant account has elapsed and the account is not placed on dormant status, is the reason documented?
22. Are signature cards for dormant accounts segregated and under dual control?
23. Who maintains the list of dormant accounts and is there dual control/segregation of duties in place to reactivate dormant accounts? Does the reactivation require approval from an officer outside the private banking department?
24. Does the branch comply with the escheating State requirements for dormant accounts?
25. Does the internal audit function review for compliance with dormant account procedures?

Refer to the Deposit Account section of this manual for more questions.

## OVERDRAFTS

26. Is there an overdraft approval schedule with limits for each officer? Are the limits reasonable?

27. Is the overdraft report reviewed and signed by management on a daily basis? If not, when is it reviewed? Are approvals within established limits?
28. Is there an overdraft aging report and is it reviewed by management?

Refer to the Deposit Accounts section of this manual for further questions.

## BILL PAYING SERVICES

29. Is there an agreement between the customer and the branch covering bill paying services? Does it specify what bills are to be paid?
30. What support documents are required as back-up for bill payments?
31. Are there adequate dual controls and review of the bill paying function?
32. Is confidential bill paying information, such as credit card numbers with expiration dates, safeguarded?
33. Are official checks used for bill paying properly controlled and inventoried?

## CREDIT CARDS

34. Does the branch provide credit cards to its customers?
35. Are there adequate procedures to safeguard the cards while they are in the branch's custody?
36. Does the customer acknowledge receipt of the card upon delivery?

## CONCLUSION

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