Commercial Bank Examination Manual
Supplement 27—May 2007

Summary of Changes

Sections 2010.3, 2040.3, and 4150.1

The "Due from Banks (Examination Procedures)," "Loan Portfolio Management (Examination Procedures)," and "Review of Regulatory Reports" sections were revised as the result of the Financial Services Relief Act of 2006 (Relief Act) and the Board's December 6, 2006, approval of an interim rule amendment of Regulation O (effective December 11, 2006). The Relief Act eliminated certain statutory reporting and disclosure requirements pertaining to insider lending by federally insured financial institutions. Sections 215.9, 215.10, and Subpart B of Regulation O were deleted as a result of the rule's changes. (See 71 *Fed. Reg.* 71,472, December 11, 2006.) The Board approved the final rule for this amendment without change on May 25, 2007 (effective July 2, 2007). (See 72 *Fed. Reg.* 30,470, June 1, 2007.)

Sections 2043.1, 2043.2, 2043.3, and 2043.4

These new "Nontraditional Mortgages—Associated Risks" sections have been developed based on the September 29, 2006, Interagency Guidance on Nontraditional Mortgage Product Risks. (See SR-06-15.) The guidance addresses both the risk-management and consumer disclosure practices that institutions (for this manual, state member banks and their subsidiaries) should employ to effectively manage the risks associated with closed-end residential mortgage loan products that allow borrowers to defer payment of principal and, sometimes, interest. Examination objectives, examination procedures, and an internal control questionnaire are provided, which should be used when conducting an examination of a bank that is engaged in such lending activities.

Section 2070.1

This "Allowance for Loan and Lease Losses" section has been fully revised to incorporate the December 13, 2006, Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL). (See SR-06-17.) The guidance updates the 1993 Interagency Guidance on the ALLL (SR-93-70). The revised policy statement emphasizes that each institution is responsible for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses. Each institution should ensure that the adequate controls are in place to consistently determine the appropriate balance of the ALLL in accordance with (1) GAAP, (2) the institution's stated policies and procedures, and (3) management's best judgment and relevant supervisory guidance. The policy emphasizes also that an institution should provide reasonable support and documentation of its ALLL estimates, including adjustments to the allowance for qualitative or environmental factors and unallocated portions of the allowance.

Section 2103.1

A new section, "Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices," sets forth the December 6, 2006, interagency supervisory guidance, which was issued jointly by the Federal Reserve and the other federal bank regulatory agencies. The guidance, effective December 12, 2006, is applicable to state member banks.

The guidance was developed to reinforce sound risk-management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets. An institution's strong risk-management practices and its maintenance of appropriate levels of capital are important elements of a sound commercial real estate (CRE) lending program, particularly when an institution has a concentration in CRE or a CRE lending strategy leading to a concentration.

The guidance applies to concentrations in CRE loans sensitive to the cyclicality of CRE markets. For purposes of this guidance, CRE loans include loans where repayment is dependent on the rental income or the sale or refinancing of the real estate held as collateral. The guidance does not apply to owner-occupied

loans and loans where real estate is taken as a secondary source of repayment or through an abundance of caution.

The guidance notes that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary depending on the portfolio risk characteristics and the quality of risk-management processes. The guidance, therefore, does not establish a CRE concentration limit that applies to all institutions. Rather, the guidance encourages institutions to perform ongoing risk assessments to identify and monitor CRE concentrations.

The guidance provides numerical indicators as supervisory monitoring criteria to identify institutions that may have CRE concentrations that warrant greater supervisory scrutiny. The monitoring criteria should serve as a starting point for a dialogue between the supervisory staff and an institution's management about the level and nature of the institution's CRE concentration risk. (See SR-07-1 and its attachments.)

Section 3020.1

The ''Assessment of Capital Adequacy'' section was revised to include an interim interagency decision on the impact of the Financial Accounting Standards Board's issuance of its September 2006 Statement of Financial Accounting Standards No. 158 (FAS 158), ''Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.'' The decision was announced in a December 14, 2006, joint press release, which was issued by the Federal Reserve Board and the other federal banking and thrift regulatory agencies (the agencies). FAS 158 provides that a banking organization that sponsors a single-employer defined benefit postretirement plan, such as a pension plan or health care plan, must recognize the overfunded or underfunded status of each such plan as an asset or a liability on its balance sheet with corresponding adjustments recognized as accumulated other comprehensive income (AOCI). The agencies' interim decision conveys that banking organizations are to exclude from regulatory capital any amounts recorded in AOCI that have resulted from their adoption and application of FAS 158.

Sections 2000.4, 2130.3, 4060.1, 4060.4, 4063.4, 4128.1, 4128.3, and 5020.1

These sections ''Cash Accounts (Internal Control Questionnaire),'' ''Consumer Credit,'' ''Information Technology'' (including the internal control questionnaire), ''Electronic Banking (Internal Control Questionnaire),'' ''Private-Banking Activities,'' (including the examination procedures), and ''Overall Conclusions Regarding Condition of the Bank,'' have been amended for the revised Suspicious Activity Report by Depository Institutions (SAR-DI) form. The Federal Reserve, along with the other federal financial institutions regulatory agencies and the Financial Crimes Enforcement Network (FinCEN), proposed revisions to this form and the instructions in order to (1) enhance their clarity, (2) allow for joint filings of suspicious activity reports, and (3) improve the usefulness of the SAR-DI form to law enforcement authorities. The new form's implementation date has not been determined. Banking organizations subject to SAR filing should continue using the existing SAR-DI format. (See 72 *Fed. Reg.* 23,891, May 1, 2007.)

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Commercial Bank Examination Manual

Supplement 26—November 2006

Summary of Changes

Sections 2040.1 and 2040.3

These "Loan Portfolio Management" sections have been revised to incorporate a May 22, 2006, Board staff interpretation of Regulation O pertaining to the use of bank-owned or bank-issued credit cards by bank insiders for the bank's business purposes. The interpretation is also concerned with the extension of credit provisions and the market-terms requirement of Regulation O when a bank insider uses the bank-owned or bank-issued credit card to acquire goods and services for personal purposes. The examination procedures have been revised to include the provisions of this interpretation.

Sections 3000.1, 3000.2, and 3000.3

The "Deposit Accounts" sections have been revised to include a brief overview of the Federal Deposit Insurance Corporation's (FDIC's) Deposit Insurance System. FDIC's deposit insurance coverage was amended by the issuance of its March 23, 2006, interim final rules (effective on April 1, 2006). These interim rules implemented certain provisions of (1) the Federal Deposit Insurance Reform Act of 2005 and (2) the Federal Deposit Insurance Reform Conforming Amendments Act of 2005. (See 71 *Fed. Reg.* 14,629.) For deposit accounts, the FDIC's interim rules provided for (1) inflation (cost-of-living) adjustments to increase the standard maximum deposit insurance amount (SMDIA) of $100,000 on a five-year cycle, beginning on April 1, 2010; (2) an increase in the FDIC's SMDIA from $100,000 to $250,000 for certain individual retirement accounts, which includes future cost-of-living adjustments; and (3) per-participant FDIC pass-through deposit insurance coverage for employee benefit accounts. (See 12 CFR 330.) The FDIC's increased insurance coverage of individual retirement accounts also applies to eligible deferred compensation plan accounts.

The "Deposit Accounts" sections also were revised to incorporate the May 11, 2001, Joint Agency Advisory on Brokered and Rate-Sensitive Deposits issued by the federal banking agencies to highlight the potential risks associated with excessive reliance on such deposits. The advisory provides guidance on prudent risk identification and the management for these types of funding. (See SR-01-14.) The examination objectives and procedures were revised to incorporate the advisory's guidance.

Section 3020.1

This section, "Assessment of Capital Adequacy," was revised to incorporate a general discussion of the risk-based capital treatment of securities-lending transactions (see 12 CFR 208, appendix A, section III.D.1.c). Included is a brief summary of the Board's February 6, 2006, revision of the Board's market-risk measure (effective on February 22, 2006). The revision reduced the capital requirements for certain cash-collateralized securities-borrowing transactions of state member banks that adopt the market-risk rule. The action aligns the capital requirements for those transactions with the risk involved. It provides a capital treatment for state member banks that is more in line with the capital treatment that applies to their domestic and foreign competitors. (See Regulation H, 12 CFR 208, appendix E, and 71 *Fed. Reg.* 8,932, February 22, 2006.)

In addition, the revised section includes discussions of the May 14, 2003, and August 15, 2006, Board interpretations that were issued in response to separate inquiries received from the same bank. The May 14, 2003, interpretation concerns an inquiry regarding the risk-based capital treatment of certain European agency securities-lending arrangements that the bank had acquired. For these transactions (the cash-collateral transactions), the bank, acting as agent for its clients, lends its clients' securities and receives cash collateral in return. It then reinvests the cash collateral in a reverse repurchase agreement for which it receives securities collateral in return. For the cash-collateral transactions, the bank indemnifies its client against the risk of default by both the securities borrower and the reverse repurchase counterparty.

The August 15, 2006, interpretation was also issued in regard to the risk-based capital treatment of certain other securities-lending transactions. For these transactions, the bank, acting as agent for clients, lends its clients' securities and

receives liquid securities collateral in return (the securities-collateral transactions). The bank indicated that the liquid securities collateral was to include government agency, government-sponsored entity, corporate debt or equity, or asset-backed or mortgage-backed securities. The bank stated that in the event that the borrower defaulted, the bank would be in a position to terminate a securities-collateral transaction and sell the collateral in order to purchase securities to replace the securities that were originally lent. The bank's exposure would be limited to the difference between the purchase price of replacement securities and the market value of the securities collateral. The bank requested that it receive risk-based capital treatment similar to that which the Board had approved and extended to the bank in its letter dated May 14, 2003 (the prior approval).

The Board, using its reservation of authority, again determined that under its current risk-based capital guidelines the capital charge for this specific type of securities-lending arrangement would exceed the amount of economic risk posed to the bank, which would result in capital charges that would be significantly out of proportion to the risk. Referencing the prior approval, the Board approved the August 15, 2006, exception to its risk-based capital guidelines. The bank, which had adopted the market-risk rule, will compute its regulatory capital for these transactions using a loan-equivalent methodology in accordance with the prior approval. In so doing, the bank will assign the risk weight of the counterparty to the exposure amount of all such transactions with the counterparty. The bank must calculate the exposure amount as the sum of its current unsecured exposure on its portfolio of transactions with the counterparty, plus an add-on amount for potential future exposure. This estimated exposure is to be calculated using the bank's VaR model to determine the capital charge for the securities-collateral transactions, subject to the certain specified conditions.

Section 4030.1

The section titled "Asset Securitization" has been revised to incorporate the August 4, 2005, Interagency Guidance on the Eligibility of Asset-Backed Commercial Paper Liquidity Facilities and the Resulting Risk-Based Capital Treatment. The guidance clarifies the application of the asset-quality test for determining the eligibility or ineligibility of an ABCP liquidity facility and the resulting risk-based capital treatment of such a facility for banks. The guidance also re-emphasizes that the primary function of an eligible ABCP liquidity facility should be to provide *liquidity*—not credit enhancement. An eligible liquidity facility must have an asset-quality test that precludes funding against assets that are (1) 90 days or more past due, (2) in default, or (3) below investment grade, implying that the institution providing the ABCP liquidity facility should not be exposed to the credit risk associated with such assets. The interagency statement indicates that an ABCP liquidity facility will meet the asset-quality test if, at all times throughout the transaction the (1) liquidity provider has access to certain types of acceptable credit enhancements that support the liquidity facility and (2) notional amount of such credit enhancements exceeds the amount of underlying assets that are 90 days or more past due, defaulted, or below investment grade, that the liquidity provider may be obligated to fund under the facility. (See SR-05-13.)

Section 4063.1

The section "Electronic Banking" was revised to incorporate a brief reference to the August 15, 2006, Interagency Questions and Answers (Q&As) for the October 2005 Interagency Guidance on Authentication in an Internet Banking Environment. (See SR-06-13 and SR-05-19.) The Q&As were designed to assist financial institutions and their technology service providers in conforming to the scope, risk assessments, timing, and other issues addressed in the October 2005 guidance that becomes effective at year-end 2006. The section notes, again, that single-factor authentication, as the only control mechanism, is inadequate for high-risk transactions involving access to customer information or the movement of funds to other parties.

Sections 4133.1 and 4133.3

These "Prompt Corrective Action" sections include several changes to more closely align the content to the Board's prompt-corrective-action (PCA) rules. Minor technical amendments that were previously made to the rules (effective on October 1, 1998) are also included.

For example, the definition of total assets was revised to allow the Federal Reserve the option of using period-end rather than average total assets for determining the PCA categories within the rules. (See 63 *Fed. Reg.* 37,630, and 12 CFR 208, subpart D.) The section now includes examination procedures for evaluating compliance with the PCA rules.

Sections 4140.1, 4140.2, 4140.3, and 4140.4

The "Real Estate Appraisals and Evaluations" sections have been revised to incorporate the June 22, 2006, interagency statement, The 2006 Revisions to Uniform Standards of Professional Appraisal Practice (USPAP), issued by the federal banking agencies. Under the appraisal regulations, institutions must ensure that their appraisals supporting federally related transactions adhere to USPAP. The interagency statement provides an overview of the USPAP revisions and the ramifications of these revisions to regulated institutions. The 2006 USPAP, effective July 1, 2006, incorporates certain prominent revisions made by the Appraisal Standards Board. These revisions include a new Scope of Work Rule and the deletion of the Departure Rule and some of its associated terminology. (See SR-06-9.)

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Summary Of Changes

Section 1000.1

This revised section, "Examination Strategy and Risk-Focused Examinations," reaffirms the definition of the responsible Reserve Bank (RRB) and specifies the RRB's responsibilities for conducting inter-District examination and supervision activities for a banking organization. The section highlights and clarifies the role of the RRB with respect to inter-District and local Reserve Bank coordination of banking examination and supervision activities. (See SR-05-27/CA-05-11.)

Sections 1010.1, 1010.2, 1010.3, 1010.4, and A.1010.1

The sections titled "Internal Control and Audit Function, Oversight, and Outsourcing" have been revised to incorporate the February 9, 2006, Interagency Advisory on the Unsafe and Unsound Use of Limitation of Liability Provisions in External Audit Engagement Letters. The advisory informs financial institutions that it is unsafe and unsound to enter into external audit contracts (that is, engagement letters) for the performance of auditing or attestation services when the contracts (1) indemnify the external auditor against all claims made by third parties, (2) hold harmless or release the external auditor from liability for claims or potential claims that might be asserted by the client financial institution (other than claims for punitive damages), or (3) limit the remedies available to the client financial institution (other than punitive damages). Such limits on external auditors' liability weaken the auditor's independence and performance, thus reducing the supervisory agency's ability to rely on the auditor's work. The examination objectives, examination procedures, and internal control questionnaire incorporate certain key provisions of the advisory. Section A.1010.1 provides examples of unsafe and unsound limitation-of-liability provisions, and it discusses frequently asked questions and answers that were posed to the Securities and Exchange Commission (Office of the Chief Accountant). The answers confirm that an accountant (auditor) is *not* independent when an accountant and a client enter into an agreement of indemnity, directly or through an affiliate that seeks to assure the accountant immunity from liability for the accountant's own negligent acts, whether they are acts of omission or commission. (See SR-06-4.)

Section 1015.1

This new section, "Conflict-of-Interest Rules for Examiners," has been developed to inform Federal Reserve System examiners of the System's policies on maintaining an independent appearance by avoiding conflicts of interest. Examiners must comply with statutory prohibitions and adhere to the System's rules on conflicts of interest, which are intended to ensure the examiners' objectivity and integrity. The statutory prohibition (18 USC 213) on accepting any loan or gratuity from any bank under examination is discussed. The limited easing of examiner borrowing restrictions on obtaining credit cards and certain home mortgage loans is also discussed; the easing of these restrictions resulted from the implementation of the Preserving Independence of Financial Institution Examinations Act of 2003 (18 USC 212–213). (See SR-05-2.) The special post-employment restrictions of the Intelligence Reform and Terrorism Prevention Act of 2004 are also reviewed. The Board implemented these restrictions in its November 17, 2005, rule (effective December 17, 2005). (See 12 CFR 263 and 264 and SR-05-26.)

Section 1020.1

The "Federal Reserve System Bank Watch List and Surveillance Programs" section has been substantially revised to reflect the Federal Reserve's replacement of the former SEER (the System to Estimate Examination Ratings) surveillance models with a new econometric framework, referred to as the Supervision and Regulation Statistical Assessment of Bank Risk model, or SR-SABR. The SR-SABR model assigns a two-component surveillance rating to each bank. The first component is the current composite CAMELS rating assigned to the bank. The second component is a letter (A, B, C, D, or

F) that reflects the model's assessment of the relative strength or weakness of a bank compared with other institutions within the same CAMELS rating category. The section describes the new model, details the screening thresholds for SR-SABR within the State Member Bank Watch List program, and updates the watch list follow-up procedures. (See SR-06-2.)

Sections 2015.1, 2015.2, 2015.3, and 2015.4

The new "Interbank Liabilities" sections set forth supervisory guidance that is based on Regulation F (12 CFR 206), which was developed under the authority of section 23 of the Federal Reserve Act (12 USC 371b-2). The Board established standards to limit the risks posed by exposure of insured depository institutions to other depository institutions with which they do business, referred to as *correspondents*. Regulation F applies to FDIC-insured banks, savings associations, and branches of foreign banks (referred to collectively as *banks*). Banks are generally required to have in place internal policies and procedures to evaluate and control the exposure to their correspondents. Regulation F specifies a general "limit," stated in terms of the exposed bank's capital, for overnight credit exposure to an individual correspondent. A bank should also ordinarily limit its credit exposure to an individual correspondent to an amount equal to not more than 25 percent of the exposed bank's total capital, unless the bank can demonstrate that its correspondent is at least "adequately capitalized," for which no capital limit is specified. A bank is required to establish and follow its own internal policies and procedures for exposure to all correspondents, regardless of its capital level. The rule was effective on December 19, 1992; the Board made technical amendments to the rule on September 3, 2003 (effective September 10, 2003). Examination objectives, examination procedures, and an internal control questionnaire are included. (See SR-93-36.)

Section 4042.3

The accounting considerations within the "Operational Risk Assessment" subsection (examination procedure 3b) were revised to remove the reference to "in excess of 25 percent of the other assets" threshold for the reporting of the cash surrender value of life insurance assets in the bank Call Report, FFIEC 031, Schedule RC-F item 5, other assets. As of March 31, 2006, this item must be used to report the cash surrender value of *all* life insurance assets.

Sections 4050.1 and 4128.1

Two sections, "Bank-Related Organizations" and "Private-Banking Activities," were revised to incorporate the Board's March 15, 2006, approval of an amendment to Regulation K. The amendment incorporates (by reference) section 208.63 of Regulation H into sections 211.5 and 211.24 of Regulation K. As a result, Edge and agreement corporations and other foreign banking organizations (that is, Federal Reserve–supervised U.S. branches, agencies, and representative offices of foreign banks) must establish and maintain procedures reasonably designed to ensure and monitor their compliance with the Bank Secrecy Act and related regulations. (See SR-06-7.)

Sections 4128.1, 4128.2, and 4128.3

The "Private-Banking Activities" section has been further revised to discuss certain borrowing mechanisms that nonresident-alien customers may establish to keep their financial assets in the United States so those assets can be used as operating capital for businesses they own and operate in their home countries. Private bankers need to maintain, in the United States, adequate customer-due-diligence information on such nonresident-alien customers and their primary business interests so that the customer's home-country government can identify who owns the assets. Examination procedures for private-banking activities (section 4128.3) have also been added.

Section 5020.1

The "Overall Conclusions Regarding Condition of the Bank" section was revised to incorporate the January 20, 2006, Interagency Guidance on Sharing Suspicious Activity Reports with Head Offices and Controlling Companies. The guidance confirms that (1) a U.S. branch or agency of

a foreign bank may disclose a Suspicious Activity Report (SAR) to its head office outside the United States and (2) a U.S. bank or savings association may disclose a SAR to controlling companies, whether domestic or foreign. Banking organizations must maintain appropriate arrangements for the protection of confidentiality of SARs. (See SR-06-01.)

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Commercial Bank Examination Manual
Supplement 24—November 2005

LIST OF CHANGES

Section number	*Description of the change*
2040.1, 2040.2, 2040.3, 2040.4	The "Loan Portfolio Management" section has been revised to incorporate the May 3, 2005, Interagency Advisory on Accounting and Reporting for Commitments to Originate and Sell Mortgage Loans, which was issued by the Federal Reserve and the other federal supervisory agencies (the agencies).[1] The advisory provides guidance on the appropriate accounting and reporting for both derivative loan commitments (commitments to originate mortgage loans that will be held for resale) and forward loan-sales commitments (commitments to sell mortgage loans). When accounting and reporting for derivative loan commitments, institutions are expected to use generally accepted accounting principles (GAAP). Institutions must also correctly report derivative loan commitments in accordance with the Call Report instructions and forms. (See SR-05-10.) The examination objectives, examination procedures, and internal control questionnaire have been revised to incorporate this interagency advisory.
2090.1, 2090.2, 2090.3, 2090.4	The section "Real Estate Loans" has been revised to include the May 16, 2005, Interagency Credit Risk Management Guidance for Home Equity Lending. The agencies issued the guidance to promote a greater focus on sound risk-management practices at financial institutions that have home equity lending programs, including open-end home equity lines of credit and closed-end home equity loans. The agencies expressed concern that some institutions' credit-risk management practices for home equity lending had not kept pace with the product's rapid growth and the easing of underwriting standards for products having higher embedded risk. The guidance highlights the sound risk-management practices an institution should follow to align the growth with the risk within its home equity portfolio. The guidance should also be considered in the context of existing regulations and supervisory guidelines. (See SR-05-11 and its attachment.) The examination objectives, examination procedures, and internal control questionnaire were revised to incorporate the interagency guidance.
3000.1	The "Deposit Accounts" section has been revised to update the statutory and regulatory provisions for a bank soliciting, acquiring, renewing, or rolling over brokered deposits, as those provisions are stated in section 29 of the Federal Deposit Insurance Act (12 USC 1831f) and section 337.6 of the Federal Deposit Insurance Corporation's brokered-deposit rule (12 CFR 337.6). Section 3000.1 defines and discusses the three capitalization status levels for banks: well capitalized, adequately capitalized, or undercapitalized. These levels determine the extent to which banks may engage in brokered-deposit activities. These definitions are the same as those found in the prompt-corrective-action rules of the FDIC and the Federal Reserve Board. (See 12 CFR 325.103 and 12 CFR 208.43.)

1. The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

Section number	*Description of the change*
4042.1, 4042.2, 4042.3, 4042.4	The "Purchase and Risk Management of Life Insurance" section has been revised to include appendix C, Interagency Interpretations of the Interagency Statement on the Purchase and Risk Management of Life Insurance (the interpretations). The interpretations have been developed to clarify a variety of matters, including financial reporting, credit-exposure limits, concentration limits, and the appropriate methods for calculating the amount of insurance an institution may purchase. Three new supporting sections provide examination objectives, examination procedures, and an internal control questionnaire. The new sections are based on the Interagency Statement on the Purchase and Risk Management of Life Insurance. (See SR-04-19 and its attachment.)
4128.1	The "Private-Banking Activities" section has been revised to include general and specific references to the relevant supervisory guidance in the June 2005 Federal Financial Institutions Examination Council's *Bank Secrecy Act/Anti–Money Laundering Examination Manual.* (See SR-05-12 and its attachments.)
4140.1	The section "Real Estate Appraisals and Evaluations" has been revised to include a summary description of the interagency responses to questions on both the agencies' appraisal regulations and the October 2003 interagency statement titled Independent Appraisal and Evaluation Functions. The agencies' March 22, 2005, interpretive responses address common questions on the requirements of the appraisal regulations and the October 2003 interagency statement. (See SR-05-5 and its attachment.) The section has also been revised to include a summary of the September 8, 2005, interagency interpretive responses to frequently asked questions that were issued jointly to help regulated institutions comply with the agencies' appraisal regulation and real estate lending requirements when financing residential construction in a tract development. (See SR-05-14 and its attachment.)
6003.1	A new section, "Community Bank Examination Report," provides the examiner with guidance on preparing examination reports for community banks. Developments in technology, the expansion of financial services, and a risk-focused approach to examinations necessitated a need for increased flexibility when organizing and structuring the content of the community bank examination report. Examiners may use certain content headings, which follow a continuous-flow reporting format, or they may use a separate-report-page format. The reporting instructions distinguish between *mandatory* content (when warranted by the bank's condition or circumstances) and *optional* content. The examiner has discretion in the arrangement of certain content. Subject to certain limitations, the examiner may customize and streamline the examination report to better focus on the examiner's findings involving matters of risk that have a significant impact on the bank's overall financial condition. This guidance applies *only* to the preparation of community bank examination reports. (See SR-01-19.)

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LIST OF CHANGES

Section number	*Description of the change*
1000.1, 4030.1	The "Examination Strategy and Risk-Focused Examinations" and the "Asset Securitization" sections have been updated to add references to the new bank holding company RFI/C(D) rating system, which became effective January 1, 2005. (See SR-04-18.)
2130.1, 2130.3, 2130.4	The "Consumer Credit" sections have been revised to discuss various types, characteristics, and fee structures of a bank's ad hoc and automatic overdraft programs. Section 2130.1 includes the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs that addresses the agencies' concerns about the potentially misleading implementation, marketing, and disclosure practices associated with the operation of these programs. Financial institutions are encouraged to review their overdraft-protection programs to make certain that their marketing and communications do not mislead consumers or encourage irresponsible consumer financial behavior that could increase the institution's risk. The guidance also addresses the safety-and-soundness considerations, risk-based capital treatment, and legal risks associated with overdraft-protection programs. (See SR-05-3/CA-05-2.) The examination procedures and the internal control questionnaire have been updated to incorporate this guidance. (See also the summary for sections 3000.1 and 3000.3.) The consumer credit examination procedures have also been updated to include references to and guidance on the Suspicious Activity Report (SAR) and the Bank Secrecy Act (BSA) compliance program. (See sections 208.62–63 of the Board's Regulation H (12 CFR 208.62–63) and SR-04-8.)
2210.1	The "Other Assets and Other Liabilities" section has been updated to coincide with current accounting guidance and the instructions for the bank Call Report. The section discusses the current examination focus, concerns, and procedures for other assets and other liabilities, as well as their current categories and composition. The section includes the accounting treatment for bank-owned life insurance (BOLI) and an improved discussion of deferred tax assets and deferred tax liabilities (including the risk-based capital limitation on their inclusion in tier 1 capital). For more information on BOLI, see SR-04-4 and SR-04-19.
3000.1, 3000.3	Two of the "Deposit Accounts" sections have been revised to include the February 18, 2005, interagency Joint Guidance on Overdraft Protection Programs that was issued to assist banks in the responsible disclosure and administration of their overdraft-protection services. The policy states that banks should establish and monitor written policies and procedures for ad hoc, automated, or other overdraft-protection programs. A bank's policies and procedures should be adequate to address the credit, operational, and other risks associated with these types of programs. (See SR-05-3/CA-05-2 and the summary for the 2130 sections.) The examination procedures have been revised to incorporate this supervisory guidance.

Section number	*Description of the change*
3015.1	A new section, "Deferred Compensation Agreements," has been added to the "Liabilities and Capital" chapter. The section provides guidance from the February 11, 2004, Interagency Advisory on Accounting for Deferred Compensation Agreements and Bank-Owned Life Insurance. The advisory was issued because the agencies, through the examination process, identified many institutions that had incorrectly accounted for obligations under a type of deferred compensation agreement commonly referred to as a *revenue-neutral plan* or an *indexed retirement plan.* The advisory informs institutions that they need to review their accounting for deferred compensation agreements to ensure that the agreements have been appropriately measured and reported. (See SR-04-4 and SR-04-19.)
4042.1	A new section, "Purchase and Risk Management of Bank-Owned Life Insurance," provides the text of the December 7, 2004, Interagency Statement on the Purchase and Risk Management of Life Insurance. The statement discusses the safety-and-soundness and risk-management implications of purchases and holdings of life insurance by banks. The agencies issued the guidance because they were concerned that some institutions may not have an adequate understanding of the risks associated with BOLI, including its liquidity, operational, reputational, and compliance/legal risks. Further, institutions may have committed a significant amount of capital to BOLI holdings without properly assessing the associated risks. When an institution is planning to acquire BOLI that will result in an aggregate cash surrender value in excess of 25 percent of its tier 1 capital plus the allowance for loan and lease losses, the agencies expect the institution to obtain the prior approval of its board of directors or its designated board committee. The guidance addresses the need for institutions to conduct comprehensive pre- and post-purchase analyses of BOLI, including its unique characteristics, risks, and rewards. Institutions are expected to have comprehensive risk-management processes for their BOLI purchases and holdings; these processes should be consistent with safe and sound banking practices. (See SR-04-4 and SR-04-19.)
4043.1	The "Insurance Sales Activities and Consumer Protection in Sales of Insurance" section has been revised to include the following references: • the recently updated discussion on tying arrangements (section 2040.1) • the new BOLI supervisory guidance (section 4042.1)
4050.1	The "Bank-Related Organizations" section has been revised to incorporate the U.S. Department of the Treasury's regulation regarding foreign correspondent accounts. The regulation became effective October 28, 2002. (See 31 CFR 103.177 (amended as of December 24, 2002) and 103.185.) The regulation implemented sections 313 and 319(b) of the USA Patriot Act. A covered financial institution (CFI) is prohibited from establishing, maintaining, administering, or managing a correspondent account in the United States for, or on behalf of, a foreign shell bank (a foreign bank that has no physical presence in the United States or other jurisdictions) that is *not* affiliated (1) with a U.S.-domiciled financial institution or (2) with a foreign bank that maintains a physical presence in the United States or a foreign country and is supervised by its home-country banking authority. A CFI that maintains

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	a correspondent account for a foreign bank in the United States must maintain records in the United States identifying the owners of the foreign bank. (See SR-03-17 and the attached October 2003 Bank Secrecy Act Examination Procedures for Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks. See also SR-01-29.)
4060.1, 4060.2, 4060.3, 4060.4	The ''Information Technology'' sections have been revised to include the Board's December 16, 2004, adoption of rule changes (effective July 1, 2005) that implement section 216 of the Fair and Accurate Credit Transactions Act of 2003 and that amend the Interagency Guidelines Establishing Information Security Standards. (See the Board's December 21, 2004, press release.) To address the risks associated with identity theft, financial institutions are required to make modest adjustments to their information security programs to develop, implement, maintain, and monitor, as part of their existing information security program, appropriate measures to properly dispose of consumer and customer information derived from credit reports (information maintained in paper-based or electronic form). Each financial institution must contractually require its service providers to develop appropriate measures for the proper disposal of the institution's consumer and customer information and, when warranted, monitor its service providers to confirm that they have satisfied their contractual obligations. The sections have also been revised to include the Board's March 21, 2005, adoption of Jointly Issued Interagency Guidance on Response Programs for Unauthorized Access to Customer Information and Customer Notice. (See the Board's March 23, 2005, press release.) Financial institutions are to develop and implement a response program designed to address incidents of unauthorized access to sensitive customer information, maintained by the institution or its service provider, that could result in substantial harm or inconvenience to the customer. Each financial institution has the flexibility to design a risk-based response program tailored to the size, complexity, and nature of its operations. Customer notice is a key feature of an institution's response program. (See Regulation H, appendix D-2, supplement A (12 CFR 208, appendix D-2, supplement A).) The examination objectives, examination procedures, and internal control questionnaire have been updated to incorporate or reference these rule changes and the interagency guidance.
4063.4	The ''Electronic Banking: Internal Control Questionnaire'' has been updated to include the following references: • SR-03-12 (and the attached July 2003 SAR form) • the Board's Regulation H requirements for suspicious-activity reporting (12 CFR 208.62) • the Board's Regulation H requirements for the BSA compliance program (12 CFR 208.63) See also SR-04-8 and the attached May 24, 2004, Interagency Advisory—Federal Court Reaffirms Protections for Financial Institutions Filing Suspicious Activity Reports.

Section number	*Description of the change*
4128.1	The ''Private Banking'' section has been revised to incorporate new and enhanced statutory requirements of the USA Patriot Act. The requirements are designed to prevent, detect, and prosecute money laundering and terrorism. For banking organizations, the act's provisions are implemented through regulations issued by the U.S. Department of the Treasury (31 CFR 103). Section 326 of the Patriot Act (codified in the BSA at 31 USC 5318(*l*)) requires financial institutions to have customer identification programs, that is, programs to collect and maintain certain records and documentation on customers. Institutions should also develop and use identity verification procedures to ensure the identity of their customers. SR-04-13 describes the BSA examination procedures for customer identification programs; examiners should follow these procedures when evaluating an institution's compliance with the regulation. (See also SR-03-17 and SR-01-29.) Relevant interagency interpretive guidance, in a question-and-answer format, addresses the customer identification rules. (See SR-05-9.)
4150.1	The ''Review of Regulatory Reports'' section has been revised to discuss the termination of the Federal Reserve's Regulatory Reports Monitoring Program. A less formal program will continue at the Reserve Banks. (See SR-04-15.)
5020.1	The ''Overall Conclusions Regarding Condition of the Bank'' section has been revised to include guidance on a bank's use of the SAR form and the filing of a SAR with the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). A bank's record-retention requirements for documentation supporting a SAR are also discussed. (See section 208.62 of the Board's Regulation H (12 CFR 206.62) and SR-04-8.) In addition, the section has been revised to include the February 28, 2005, Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information. The advisory reminds banking organizations of the statutory prohibitions on the disclosure of supervisory ratings and other confidential supervisory information to third parties. (See SR-05-4.)
7000.0	The ''International'' section has been revised to convey an overview of the examination focus for international banking transactions and activities. The discussion of other examination topics and Federal Reserve System and FFIEC examination manuals has been updated for those international areas that may be need to be reviewed during a bank examination.
7000.1	The former ''International—General Introduction'' section has been renamed ''International—Examination Overview and Strategy.'' The revised title better reflects the content of the sections that follow, which provide the examination and supervisory guidance for international transactions, activities, and international banking. References and other section titles were also updated.

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LIST OF CHANGES

Section number	*Description of the change*
1000.1	The "Examination Strategy and Risk-Focused Examinations" section incorporates a May 2004 recommended-practices document promulgated by the interagency State-Federal Working Group. The working group consists of state bank commissioners and senior officials from the Federal Reserve and the Federal Deposit Insurance Corporation.[1] The recommended practices highlight the importance of communication and coordination between state and federal banking agencies in the planning and execution of supervisory activities over state-chartered banking organizations. The recommended practices are the common courtesies and practices examination and supervisory staff are to follow in the implementation and execution of their agencies' supervisory activities. These recommended practices further reinforce the long-standing commitment of federal and state banking supervisors to provide efficient, effective, and seamless oversight of state banks of all sizes. The practices apply to institutions that operate in a single state or in more than one state. (See SR-04-12.)
2020.1, 2020.3	The "Investment Securities and End-User Activities" section has been updated to include the revised Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts (the uniform agreement) that was jointly issued by the federal banking and thrift agencies (the agencies) on June 15, 2004. The revised uniform agreement amends the 1938 classification of securities agreement (the 1938 accord), which was revised on July 15, 1949, and May 7, 1979. The uniform agreement sets forth the definitions of the classification categories and the specific examination procedures and information for classifying bank assets, including securities. The classification of loans in the uniform agreement was not changed by the June 2004 revision. The revised uniform agreement addresses, among other items, the treatment of rating differences, multiple security ratings, and split or partially rated securities. It also eliminates the automatic classification for sub-investment-grade debt securities. (See SR-04-9.) The examination procedures were also revised to incorporate the supervisory guidance provided in the revised uniform agreement.
2040.1, 2040.2, 2040.3	The "Loan Portfolio Management" section has been revised to incorporate a detailed discussion on tying arrangements. Section 106 of the Bank Holding Company Act Amendments of 1970 generally prohibits a bank from conditioning the availability or price of one product or service (the *tying product*, or the *desired product*) on a requirement that a customer obtain another product or service (the *tied product*) from the bank or an affiliate of the bank. Section 106 prevents banks from using their market power over certain products (specifically credit) to gain an unfair competitive advantage in other products.

1. The source for the recommended-practices document is the November 14, 1996, Nationwide State and Federal Supervisory Agreement (the agreement) to enhance the overall state-federal coordinated supervision program for state-chartered banks. The agreement provides for the supervision of state-chartered banks that have interstate branches. (See SR-96-33.)

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	Section 106 also prohibits a bank from conditioning the availability or price of one product on a requirement that a customer (1) provide another product to the bank or an affiliate of the bank or (2) not obtain another product from a competitor of the bank or from a competitor of an affiliate of the bank. For example, the statute prohibits a bank from requiring that a prospective borrower purchase homeowners' insurance from the bank or an affiliate of the bank to obtain a mortgage loan from the bank. Section 106 contains several exceptions to its general prohibitions, and it authorizes the Board to grant, by regulation or order, additional exceptions from the prohibitions when the Board determines an exception "will not be contrary to the purposes" of the statute. Under the federal banking laws, a subsidiary of a bank is considered to be part of the bank for most supervisory and regulatory purposes. Therefore, the restrictions in section 106 generally apply to tying arrangements imposed by a subsidiary of a bank in the same manner that the statute applies to the parent bank itself. Thus, a subsidiary of a bank is generally prohibited from conditioning the availability or price of a product on the customer's purchase of another product from the subsidiary, its parent bank, or any affiliate of its parent bank. Section 106 generally does not apply to tying arrangements imposed by a nonbank affiliate of a bank. In addition to the regulatory prohibitions and exceptions, this section includes the Board or Board staff interpretations on tying arrangements, including those issued on August 18, 2003, and February 2, 2004. These two interpretations state that bank customers that receive securities-based credit can be required to hold their pledged securities as collateral at an account of a bank holding company's or bank's broker-dealer affiliate. The examination objectives and examination procedures have also been revised to address tying arrangements.
3000.1, 3000.2, 3000.3, 3000.4	The "Deposit Accounts" section has been revised to incorporate the June 15, 2004, interagency advisory "Guidance on Accepting Accounts from Foreign Governments, Foreign Embassies, and Foreign Political Figures." The advisory was issued by the federal banking and thrift agencies (the agencies) and the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN). The advisory was issued in response to inquiries the agencies and FinCEN received on whether financial institutions should do business and establish account relationships with the foreign customers cited in the advisory. Banking organizations are advised that the decision to accept or reject such foreign-account relationships is theirs alone to make. Financial institutions are to be aware that there are varying degrees of risk associated with these accounts, depending on the customer and the nature of the services provided. Institutions should take appropriate steps to manage these risks, consistent with sound practices and applicable anti-money-laundering laws and regulations. (See SR-04-10.) The examination objectives, examination procedures, and internal control questionnaire were also revised to incorporate the advisory's supervisory guidance.
3020.1, 3020.3	The "Assessment of Capital Adequacy" section has been updated to include provisions of a final rule revision pertaining to a bank's risk-based capital requirements for asset-backed commercial paper (ABCP) programs. The

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	Board approved the rule changes on July 17, 2004 (effective September 30, 2004). See appendix A of Regulation H (12 CFR 208, appendix A). In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" (FIN 46). FIN 46 required, for the first time, the consolidation of variable interest entities (VIEs) onto the balance sheets of companies deemed to be the primary beneficiaries of those entities. In December 2003, FASB revised FIN 46 as FIN 46-R. (The interpretation (FIN 46 or FIN 46-R) was effective for reporting periods that ended as early as December 15, 2003. However, there are various effective dates, which are determined on the basis of the nature, size, and type of business entity.) FIN 46-R requires the consolidation of many ABCP programs onto the balance sheets of banking organizations. Under the Board's revised risk-based capital rule, a bank that qualifies as a primary beneficiary and must consolidate an ABCP program that is defined as a variable interest entity under generally accepted accounting principles may exclude the consolidated ABCP program's assets from risk-weighted assets provided that it is the sponsor of the program. Banks must also hold risk-based capital against eligible ABCP liquidity facilities with an original maturity of one year or less that provide liquidity support to ABCP by applying a new 10 percent credit-conversion factor to such facilities. Eligible ABCP liquidity facilities with an original maturity exceeding one year remain subject to the rule's current 50 percent credit-conversion factor. Ineligible liquidity facilities are treated as direct-credit substitutes or recourse obligations, which are subject to a 100 percent credit-conversion factor. When calculating the bank's tier 1 and total capital, any associated minority interests must also be excluded from tier 1 capital. The examination procedures were also revised to incorporate the revised risk-based capital requirements.
4030.1, 4030.2, 4030.3, 4030.4	The "Asset Securitization" section has been revised to incorporate the Board's July 17, 2004, approval (effective September 30, 2004) of a final rule to the risk-based capital requirements for ABCP programs and their liquidity facilities. For more details, see the summary for section 3020.1. The examination objectives, examination procedures, and internal control questionnaire were also revised to incorporate the revised rule for ABCP programs.
4125.1, 4125.3	The "Payment System Risk and Electronic Funds Transfer Activities" section incorporates the Board's September 22, 2004, changes to its Policy on Payments System Risk (the PSR policy). (See 69 *Fed. Reg.* 57917, September 28, 2004, and 69 *Fed. Reg.* 69926, December 1, 2004.) Effective July 20, 2006, the PSR policy requires Reserve Banks (1) to release interest and redemption payments on securities issued by government-sponsored enterprises (GSEs) and certain international organizations (institutions for which the Reserve Banks act as fiscal agents but whose securities are not obligations of, or fully guaranteed as to principal and interest by, the United States) only if the issuer's Federal Reserve account contains sufficient funds to cover them and (2) to align the treatment of the general corporate account activity of GSEs and certain international organizations with the treatment of

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	the activity of other account holders that do not have regular access to the discount window and those account holders not eligible for intraday credit. The examination procedures have also been updated to incorporate the revisions to the Board's PSR policy.

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LIST OF CHANGES

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1010.1	This revised section on internal control and audit function, oversight, and outsourcing incorporates a brief overview of the joint final rules adopted by the Board and the other federal bank and thrift regulatory agencies. (See the Board's August 8, 2003, press release.) Section 36 of the Federal Deposit Insurance Act, as implemented by 12 CFR 363, governs the agencies' authority to take disciplinary actions against independent accountants and accounting firms that perform audit and attestation services required by the act. Attestation services address management's assertions concerning internal controls over financial reporting. An insured depository institution must include the accountant's audit and attestation reports in its annual report. The joint final rules established the practices and procedures under which the agencies can, for good cause, remove, suspend, or bar an accountant or firm from performing audit and attestation services for federally insured depository institutions with assets of $500 million or more. The rules became effective October 1, 2003.
2040.1, 2040.3, A.2040.3	Two of the loan portfolio management sections were revised to provide references to accounting pronouncements that apply to mortgage banking transactions and activities and that are consistent with the bank call report instructions. Comprehensive mortgage banking examination procedures are provided in the new section A.2040.3 (in the appendix to the manual). The comprehensive procedures address the examination, supervisory, and valuation concerns discussed in the following guidance: the February 25, 2003, Interagency Advisory on Mortgage Banking; SR-03-4, "Risk Management and Valuation of Mortgage Servicing Assets Arising from Mortgage Banking Activities"; the mortgage banking examination modules; and many of the mortgage banking inspection (examination) procedures found in section 3070.0 of the *Bank Holding Company Supervision Manual.*
2070.1	This section on the allowance for loan and lease losses (ALLL) was revised to include references to updated accounting guidance, SR-04-5, and the March 1, 2004, interagency Update on Accounting for Loan and Lease Losses. The interagency update covers recent developments in accounting, current sources of generally accepted accounting principles, and supervisory guidance that applies to the ALLL. Other SR-letters associated with the supervisory guidance for the ALLL are referenced. (See also section 2072.1.)
2100.1, 2100.4	The section on real estate construction loans and the respective internal control questionnaire were revised to incorporate the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions and, to a limited extent, the supervisory guidance in SR-03-18. (See the summary for section 4140.1 below.)
4050.1	The section on bank-related organizations was revised to include brief definitions and descriptions of the limited activities and services authorized in Regulation K for foreign bank offices and organizations (that is, foreign bank branches, agencies, commercial lending companies, representative

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	offices, and correspondent banks). For the purposes of sections 23A and 23B of the Federal Reserve Act, the definition of affiliate was also clarified and expanded on the basis of the provisions of the Board's Regulation W.
4140.1, 4140.3, 4140.4	The section on real estate appraisals and evaluations and the respective examination procedures and internal control questionnaire were revised to reference and incorporate the October 27, 2003, interagency statement on Independent Appraisal and Evaluation Functions. A banking institution's board of directors is responsible for reviewing and adopting policies and procedures that establish and maintain an effective, independent real estate appraisal and evaluation program (the program) for all of its lending functions. Concerns about the independence of appraisals and evaluations arise from the risk that improperly prepared appraisals may undermine the integrity of credit-underwriting processes. An institution's lending functions should not have undue influence that might compromise the program's independence. Institutions may not use an appraisal prepared by an individual who was selected or engaged by a borrower. Likewise, institutions may not use "readdressed appraisals"—appraisal reports that are altered by the appraiser to replace any references to the original client with the institution's name. Altering an appraisal report in a manner that conceals the original client or intended users of the appraisal is misleading and violates the agencies' appraisal regulations and the Uniform Standards of Professional Appraisal Practice (USPAP). (See SR-03-18.)
4180.1, 4180.2, 4180.3, 4180.4	These new sections discuss the January 5, 2004, Interagency Policy on Banks/Thrifts Providing Financial Support to Funds Advised by the Banking Organization or Its Affiliates. The policy alerts banking organizations, including their boards of directors and senior management, to the safety-and-soundness implications of and the legal impediments to a bank providing financial support to investment funds advised by the bank, its subsidiaries, or affiliates (that is, an affiliated investment fund). The interagency policy emphasizes the following three core principles. A bank should not— • inappropriately place its resources and reputation at risk for the benefit of affiliated investment funds' investors and creditors; • violate the limits and requirements in Federal Reserve Act sections 23A and 23B and Regulation W, other applicable legal requirements, or any special supervisory condition imposed by the agencies; or • create an expectation that the bank will prop up the advised fund (or funds). In addition, bank-affiliated investment advisers are encouraged to establish alternative sources of financial support to avoid seeking support from affiliated banks. A bank's investment advisory services can pose material risks to the bank's liquidity, earnings, capital, and reputation and can harm investors, if the risks are not effectively controlled. Bank management is expected to notify and consult with its appropriate federal banking agency before (or, in an emergency, immediately after) providing material financial support to an affiliated investment fund. (See SR-04-1.) Examination

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	objectives, examination procedures, and an internal control questionnaire have been provided to address the supervisory concerns set forth in the policy.

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