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2260.0		Venture Capital
	2260.0.1	Introduction

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Introduction To Topics For Supervisory Review

Section 2000.0

Discussed within these subsections are topics associated with regard to the overall bank holding company organization. Included is general information, inspection objectives and procedures, and in some instances references to laws, interpretations, and Board orders. The primary topics addressed are the supervision of subsidiaries, grandfather rights, commitments, extensions of credit to BHC officials, management information systems, taxes, funding, control and ownership, reporting by foreign and domestic banking organizations, formal corrective actions, sharing of criminal referral information, investment transactions, recognition and control of risk, purchase and sale of U.S. Government guaranteed loans, and venture capital.

The relative merit of the degree of supervision is dependent upon a number of factors, and must be analyzed in light of efficiency and operating performance. The degree and nature of control over subsidiary organizations in a holding company system usually falls between two extremes: a tightly controlled, centralized network similar to a branch system, or a loosely controlled, decentralized system with each subsidiary operating autonomously. A bank holding company might originate as a ''shell'' corporation organized by investors interested in purchasing a bank, or by a bank interested in reorganizing into a holding company structure in order to expand through acquisition of nonbank concerns or other banks. The management and directorate of such a holding company are often the same as that of the bank. As the holding company expands through acquisitions, the parent may continue to exercise control through the staff of the lead bank, or may form a separate staff to overview the operations of all subsidiaries. The relative merit of the degree of supervision is dependent upon a number of factors, and must be analyzed in light of efficiency and operating performance.

The level at which policies are established and supervised, the frequency of contact between the parent and subsidiaries, and the extent to which officers and directors of the parent serve also as officers and directors of the subsidiary organizations are indicative of the level of control exercised by the parent. A centralized bank holding company is characterized by the placement of directors and officers of the parent company (or those of the lead bank) in each of its subsidiaries, with frequent group meetings held between the officers of the lead bank or holding company and those of the subsidiary organizations. While this is an efficient method of operation, this type of organization builds in the potential for conflicts of interest for those individuals who serve in dual capacities. Corporate policies should recognize this potential and provide guidance for resolution. The overriding principle should be that *no* member of the bank holding company organization should be disadvantaged by a transaction with another affiliate. Management of the investment portfolio, budgets, tax planning, personnel, correspondent relationships, loans and loan participations, and liability management are usually controlled by the parent or lead bank in a centralized system.

A decentralized system is one in which the banks act independently of the parent company, with infrequent contacts with affiliates, placement of parent or lead bank directors and officers in less than a majority of the banks within the system and infrequent reporting by subsidiaries concerning investments and operating performance. The bank holding company might act only in a minor advisory capacity. In such a decentralized system each subsidiary operates as a relatively autonomous unit, with authority and responsibility for certain actions delegated by the parent to the board and/or chief executive officer of each subsidiary.

It is the responsibility of the directors and management of the parent company to establish and supervise the policies of subsidiaries, either directly or through delegation of authority. The importance of written policies in a delegated, decentralized organization cannot be overemphasized, and the selection of qualified officers to carry out policies is equally important. If written policies have not been developed by the holding company, the examiner should recommend that major policies be written and communicated to subsidiaries. Policies should ensure that subsidiaries are not managed for cross purposes and should avoid concentrations of risks on a consolidated basis.

2010.0.1 POLICY STATEMENT ON THE RESPONSIBILITY OF BANK HOLDING COMPANIES TO ACT AS SOURCES OF STRENGTH TO THEIR SUBSIDIARY BANKS

The Board is concerned about situations where a bank has been threatened with failure notwithstanding the availability of resources to its parent bank holding company. In order to assure that the Board's policy that bank holding companies serve as sources of financial strength to subsidiary banks is understood by bank holding companies, the Board has issued a general policy statement reaffirming and articulating these principles, and confirming that the policy applies to failing bank situations. This long-standing policy has been recognized by the Supreme Court in its decision in *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234 (1978), and has been incorporated explicitly in the Board's Regulation Y, 12 C.F.R. 225.4(a)(1).

A fundamental and long-standing principle

underlying the Federal Reserve's supervision and regulation of bank holding companies is that bank holding companies should serve as sources of financial and managerial strength to their subsidiary banks. It is the policy of the Board that in serving as a source of strength to its subsidiary banks, a bank holding company should stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and should maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks in a manner consistent with the provisions of this policy statement.

Since the enactment of the Bank Holding Company Act in 1956, the Board has formally stated on numerous occasions that a bank holding company should act as a source of financial and managerial strength to its subsidiary banks. As the Supreme Court recognized, in the 1978 *First Lincolnwood* decision, Congress has expressly endorsed the Board's long-standing view that holding companies must serve as a ''source of strength to subsidiary financial institutions.''[1] In addition to frequent pronouncements over the years and the 1978 Supreme Court decision, this principle has been incorporated explicitly in Regulation Y since 1983. In particular, Section 225.4(a)(1) of Regulation Y provides that:

> "A bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner."

The important public policy interest in the support provided by a bank holding company to its subsidiary banks is based upon the fact that in acquiring a commercial bank, a bank holding company derives certain benefits at the corporate level that result, in part, from the ownership of an institution that can issue federally-insured deposits and has access to Federal Reserve credit. The existence of the federal ''safety net'' reflects important governmental concerns regarding the critical fiduciary responsibilities of depository institutions as custodians of depositors' funds and their strategic role within our economy as operators of the payments system and impartial providers of credit. Thus, in seeking the advantages flowing from the ownership of a commercial bank, bank holding companies have an obligation to serve as a source of strength and support to their subsidiary banks.

An important determinant of a bank's financial strength is the adequacy of its capital base. Capital provides a buffer for individual banking organizations to absorb losses in times of financial strain, promotes the safety of depositors' funds, helps to maintain confidence in the banking system, and supports the reasonable expansion of banking organizations as an essential element of a strong and growing economy. A strong capital cushion also limits the exposure of the federal deposit insurance fund to losses experienced by banking institutions. For these reasons, the Board has long considered adequate capital to be critical to the soundness of individual banking organizations and to the safety and stability of the banking and financial system.

Accordingly, it is the Board's policy that a bank holding company should not withhold financial support from a subsidiary bank in a weakened or failing condition when the holding company is in a position to provide the support. A bank holding company's failure to assist a troubled or failing subsidiary bank under these circumstances would generally be viewed as an unsafe and unsound banking practice or a violation of Regulation Y or both.

Where necessary, the Board is prepared to take supervisory action to require such assistance. Finally, the Board recognizes that there may be unusual and limited circumstances where flexible application of the principles set forth in this policy statement might be necessary, and the Board may from time to time identify situations that may justify exceptions to the policy.

This statement is not meant to establish new principles of supervision and regulation; rather, as already noted, it builds on public policy considerations as reflected in banking laws and regulations and long-standing Federal Reserve supervisory policies and practices. A bank holding company's failure to meet its obligation to serve as a source of strength to its subsidiary bank(s), including an unwillingness to provide appropriate assistance to a troubled or failing bank, will generally be considered an unsafe and unsound banking practice or a violation of Regulation Y, or both, particularly if appropriate resources are on hand or are available to the bank holding company on a reasonable basis. Consequently, such a failure will generally result in the issuance of a cease and desist order or other enforcement action as authorized under banking law and as deemed appropriate under the circumstances.

1. *Board of Governors* v. *First Lincolnwood Corp.,* 439 U.S. 234, 252 (1978), citing S. Rep. No. 95–323, 95th Cong., 1st Sess. 11 (1977).

2010.0.2 BOARD ORDER REQUESTING A WAIVER FROM THE BOARD'S SOURCE OF STRENGTH POLICY

On December 23, 1991, the Board approved an application of a BHC to eventually acquire 100 percent of the outstanding stock of another BHC under a 5 year option. Initially, the BHC would acquire approximately 26 percent of the acquiree's total capital by purchasing a 15-year subordinated capital note agreement. It would then have the option to acquire all of the remaining stock within 5 years. The acquiring BHC requested that the Board waive any requirement of the Board that it serve as a source of financial strength to the subsidiary bank (the Board's "Source of Strength" policy) of the BHC acquired until such time that the option is exercised to acquire the actual ownership of all the shares. The Board considered the request and determined that it would not be appropriate to waive the responsibility to serve as a source of financial strength to the bank in this case. The Board noted that the option agreement and the capital note agreement together provide a mechanism for the acquiring BHC to exert control over the future ownership of the acquired BHC and many of the most important management decisions. Refer to 1992 FRB 159 and the F.R.R.S. at 4-271.3.

2010.0.3 INSPECTION OBJECTIVES

1. To determine whether the board of directors of the parent company is cognizant of and performing its duties and responsibilities.
2. To determine the adequacy of written policies and compliance with such policies by the parent and its subsidiaries.
3. To determine whether the board is properly informed as to the financial conditions, trends and policies of its subsidiaries.
4. To determine the level of supervision over subsidiaries and whether the supervision as structured has a beneficial or detrimental effect upon the subsidiaries.

2010.0.4 INSPECTION PROCEDURES

1. Determine if the holding company maintains its own staff, or whether the holding company management and directorate are the same as those of a subsidiary.
2. Determine whether the board of directors of the parent company reviews the audit reports, regulatory examination reports, and board minutes of its subsidiaries.
3. Determine the extent to which subsidiaries rely upon the parent for investment and lending guidance.
4. Determine which specific functions and decisions are performed only at the parent company level.
5. Determine the extent to which representatives of the parent company serve as officers and/or directors of subsidiaries.
6. Review minutes of the board and executive committees of the parent to determine whether the parent company reviews loan delinquency reports, comparative balance sheets and comparative income statements of the subsidiaries.
7. Review the extent of influence and control over both bank and nonbank subsidiaries.
8. Determine the degree of influence by the parent company over:
   a. Appointment of officers;
   b. Salary administration;
   c. Budget and tax planning;
   d. Capital expenditures;
   e. Dividend policy;
   f. Investment portfolio management;
   g. Loan portfolio management;
   h. Asset/liability and interest rate/risk management.
9. Determine the degree to which management of the subsidiary companies interfaces with management of the parent company to discuss policies.

The responsibility for the performance of the organization rests with the board of directors of the parent company. Parent company management should have policies in place to prevent funding practices that put at risk the welfare of the subsidiary banks or the consolidated organization.

The parent's supervision and control of subsidiary funding activities and the funding between itself and its subsidiaries should be thus evaluated. The parent should be expected to maintain policies for itself and its subsidiaries that provide guidance and controls for funding practices. The presence and wording of funding policies and the degree to which the policies are followed by the subsidiaries, and the effectiveness of the policies in reducing risk to the entire organization should also be assessed.

The importance of the parent's involvement in funding decisions and the need for monitoring and control at the parent level needs to be emphasized. As a minimum, the parent's funding policies should address the following areas:

1. *Capitalization*—The holding company's policy on capital levels should address capital for the bank subsidiaries, the nonbank subsidiaries, and the consolidated organization. The policy for bank and consolidated capital should be consistent with the Board's Capital Adequacy Guidelines and should address the asset quality of the entity in question. The policy for nonbank capital should include maintaining the capital level at industry standards and should also address the asset quality of the subsidiary, the holding company's capital for each entity should address what measures would be taken in the event capital falls below a targeted level.

Capital should also be addressed at the parent company level by specifying the degree of ***double leverage*** that the parent is willing to accept. The parent's capital policy should provide some measure of assessing each individual subsidiary's capital adequacy in the context of the double leverage within the organization.

The capital policies should include the method for calculating dividends from each entity. The amount of dividends from subsidiaries to the parent is affected by the parent's philosophy on the distribution of capital throughout the organization. Some companies tend to keep minimum capital levels in their subsidiary banks by transferring the excess capital to the parent in the form of dividends. The parent then invests these funds for its own benefit, and downstreams the funds as needed. Other companies calculate dividends based strictly on the parent's cash needs and thus keep any excess capital at the bank level.

2. *Asset/Liability Management*—The holding company's policies in the area of *asset/liability management should include interest rate sensitivity matching, maturity matching, and the use of interest rate futures and forwards.* These topics should be addressed for each entity as well as the organization as a whole. It is the parent's responsibility to see that each entity is operating consistently with the corporate goals.

The ***interest rate sensitivity policies*** should be designed to reduce the organization's vulnerability to interest rate movements. Policies concerning the asset/liability rate sensitivity match should not be limited to the subsidiary lead bank. The rate charged on parent company debt and the rate received by the parent on its advances to subsidiaries should also be addressed to monitor the parent's ability to service its debt in the face of changing interest rates. The policy should specify what degree of mismatching is considered acceptable. The interest rate sensitivity matching of the organization should be monitored on a frequent basis through the timely preparation of a matching schedule.

Maturity matching policies should be designed to provide adequate liquidity to the organization. These policies should not be limited to the subsidiary lead bank, since a parent company serving as a funding vehicle for nonbank subsidiaries can have substantial exposure through its advances to these subsidiaries. The holding company's policies should include some measure of the liquidity of the assets in the nonbank subsidiary (determined partially by the quality of these assets), for comparison against the parent's source of funding. The policies should quantify the maximum degree of exposure in the organization that is considered acceptable to management. The reporting in this area should clearly indicate the current exposure and thus the potential for liquidity problems.

The holding company's ***policies addressing interest rate futures and forwards*** should be consistent with the Board's policy in this area. Involvement in this activity should be geared towards hedging against interest rate movements rather than speculating that interest rates will either increase or decrease. The policy

should specify what use of futures and forwards is considered appropriate.

3. *Funding of Nonbank Subsidiaries*—The parent company should have policies addressing how nonbank subsidiaries fund their activities. If the subsidiaries obtain their own funding, market discipline may be a factor in controlling the activities of the subsidiaries. However, the parent cannot rely solely on market discipline due to the risks from interdependence. The parent company is still responsible under the centralized accountability approach to approve and supervise the subsidiaries' funding policies.

If the subsidiaries obtain funds from the parent, the risk from interdependence is increased. The subsidiary is less able to stand alone since it is reliant on the parent for funding. If the parent capitalizes the nonbank subsidiary through borrowed funds, bank capital is put at risk due to the increased exposure of the organization. If the borrowing results in ***double-leverage***, the risk is increased since less "hard" capital is available for support. The parent's policy on advances to nonbank subsidiaries should address this additional risk by specifying the level of borrowings that is considered acceptable relative to nonbank capital and consolidated capital. The terms of the borrowings should also be specified, and should be consistent with the company's asset/liability management policies. The policy should include contingency measures to be used in the event of liquidity problems.

2010.1.1 INSPECTION OBJECTIVES

1. To determine if the parent's funding policies adequately address funding risks to the organization.
2. To determine if the implementation of the parent's policies is effective in controlling funding risks to the organization.
3. To determine if the parent is adequately informed of actual funding practices and decisions.

2010.1.2 INSPECTION PROCEDURES

1. Review the funding policies at the parent and the subsidiary levels.
2. Determine how effectively the policies are implemented throughout the organization.
3. Discuss with management the funding practices of each subsidiary and any interorganizational funding.

The examiner should make a qualitative assessment of the parent's supervision and control of subsidiary lending activities. The System's ability to evaluate the effectiveness of a company's supervision and control of subsidiary lending activities can be strengthened not only by evaluating the parent's role in light of efficiency and operating performance, but also by evaluating the *quality* of control and supervision.

In order to assess quality, there must be a standard measure against which a company's policies can be evaluated. Establishing the minimum areas that a company's loan-administration policies should address will create a standard that will aid in evaluating the quality of the company's control and its supervision of that activity.

Current inspection procedures include the testing of subsidiaries' compliance with a parent company's policies. This section summarizes the parent's responsibilities with regard to supervising subsidiary lending. It defines the internal and external factors that should be considered in the formulation of loan policies and a strategic plan. It also outlines the minimum elements that the lending policies should include.

Internal and external factors that a banking organization should consider when formulating its loan policies and strategic plan are—

1. the size and financial condition of the credit-extending subsidiaries;
2. the expertise and size of the lending staff;
3. the need to avoid undue concentrations of risk;
4. compliance with all respective laws and regulations; and
5. market conditions.

Following are the components that generally form the basis for a sound loan policy:

1. *Geographic limits.* The trade area should be clearly defined and loan officers should be fully aware of specific geographic limitations for lending purposes. Such a policy avoids approval of loans to customers outside the trade area in opposition to primary objectives. The primary trade area should be distinguished from any secondary trade area so that emphasis may be properly placed.
2. *Distribution of loans by category.* Limitations based on aggregate percentages of total loans in commercial, real estate, consumer, and other categories are common. Such policies are beneficial; however, they should contain provisions for deviations that are approved by the directorate or a committee. This allows credit to be distributed in relation to the market conditions of the trade area. During times of heavy loan demand in one category, an inflexible loan-distribution policy would cause that category to be slighted in favor of another. Deviations from loan distributions by category may be beneficial but are appropriate only until the risk of further increasing the loan concentration outweighs the benefits to be derived from expanding the portfolio to satisfy credit demand. See component 11, "Concentrations of credit," below.
3. *Types of loans.* The lending policy should state the types of loans that will be made and the maximum amount for each type of loan. The policy should also set forth guidelines to follow in making specific loans. Decisions about the types of loans to be granted should be based on the expertise of the lending officers, the deposit structure, and anticipated creditworthy demands of the trade area. Sophisticated credits or loans secured by collateral that require more than normal supervision should be avoided unless or until there are the necessary personnel to properly administer them. Information systems and internal controls should be in place to identify, monitor, and control the types of credit that have resulted in abnormal loss. The amount of real estate and other types of term loans should be considered in relation to the amount of stable funds.
4. *Maximum maturities.* The loan policy should call for underwriting standards that ensure realistic repayment plans. Loan maturities should be set by taking into consideration the anticipated source of repayment, the purpose of the loan, the type of property, and the useful life of the collateral. For term loans, the lending policy should state the maximum time within which loans may be amortized. Specific procedures should be developed for situations requiring balloon payments and/or modification of the original terms of the

loan. If a clean-up period[1] is required, that period should be explicitly stated.

5. *Loan pricing.* Rates on various loan types must be sufficient to cover the cost of funds loaned and the servicing of the loan, including overhead and possible losses, while providing an acceptable margin of profit over the long run. These costs must be known and taken into consideration before rates are established. Periodic reviews should be conducted to determine whether adjustments are necessary to reflect changes in costs or competitive factors. Specific guidelines for other factors, such as compensating balances and commitment fees, are also germane to loan pricing.
6. *Loan amount to appraised value.* The policy should outline where the responsibility for appraisals rests and should define formal, standard appraisal procedures, including procedures for possible reappraisals in case of renewal or extension. Acceptable types of appraisals and limits on the dollar amount and the type of property that personnel are authorized to appraise should be outlined. Circumstances requiring appraisals by qualified independent appraisers should be described. The maximum ratio of the loan amount to appraised value,[2] the method of valuation, and differences for various types of property should be detailed. The policy should contain a schedule listing the downpayment requirements for financing consumer goods and business equipment.
7. *Loan amount to market value of pledged securities.* In addition to the legal restrictions imposed by Federal Reserve Regulation U, the lending policy should set forth margin requirements for all types of securities acceptable as collateral. Margin requirements should be related to the marketability of the security (for example, closely held, over-the-counter, actively traded). The policy should assign responsibility and set a frequency for the periodic pricing of the collateral.
8. *Financial information.* Extension of credit on a safe and sound basis depends on complete and accurate information regarding the borrower's credit standing. One possible 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, including secondary sources of repayment, not only at the inception of the loan, but also throughout the term of the advance. The lending policy should define the financial-statement requirements for businesses and individuals at various borrowing levels and should include requirements for audited, nonaudited, fiscal, interim, operating, cash-flow, and other statements.[3] It should include external credit checks required at various intervals. The requirements for financial information should be defined in such a way that any credit-data exception would be a clear violation of the lending policy.
9. *Limits and guidelines for loan participations.* Section 2020.2 provides significant information regarding intercompany loan participations between holding company affiliates. The lending policy should place limits on the amount of loans purchased from any one source and also place an aggregate limit on such loans. The policy should set forth credit standards for any loan purchased as well as require that complete documentation be maintained by the purchasing entities. The policy should define the extent of contingent liability, holdback and reserve requirements, and the manner in which the loan will be handled and serviced.
10. *Loans to insiders.* Lending policies should address loans to insiders. Such policies should incorporate applicable regulatory

1. A "clean-up period" is when a borrower is asked to repay the entire balance of a credit line and to refrain from further borrowing for a specified period of time.
2. This is often referred to as the loan-to-value ratio.
3. On March 30, 1993, federal bank regulators set forth an expanded interagency policy to encourage small-business lending. Under the policy, banks and thrifts that are well or adequately capitalized and that are rated CAMELS 1 or 2 may make small-business and agricultural loans, the aggregate value of which cannot exceed 20 percent of their total capital. To qualify for the exemption, each loan may not exceed the lesser of $900,000 or 3 percent of the institution's total capital. Further, the loans selected for this exemption by the institution may not be delinquent as of the selection date and may not be made to an insider. The loans must be separately listed or have an accounting segregation from other loans in the portfolio. They "will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation." The institution's records must include an evaluation of its ability to collect the loan in determining the adequacy of its allowance for loan and lease losses. If a loan becomes more than 60 days past due, it may be reviewed and classified by an examiner based on its credit quality, not the level of loan documentation.

limitations (for example, Federal Reserve Regulation O) and should also address situations in which it would be prudent to exercise certain restrictions even though not explicitly required to do so by regulation (for example, loans by nonbank subsidiaries to insiders).

11. *Concentrations of credit.* Credit concentrations may be defined as loans collateralized by a common security; loans to one borrower or related group of borrowers; loans dependent upon a particular agricultural commodity; aggregate loans to major employers, their employees, and their major suppliers; loans within industry groups; out-of-territory loans; aggregate amount of paper purchased from any one source; or those loans that often have been included in other homogeneous risk groupings. Credit concentrations, by their nature, are dependent on common key factors, and when weaknesses develop, they have an adverse impact on each individual loan making up the concentration.

    In identifying asset concentrations, commercial real estate loans and residential real estate loans can be viewed separately when their performance is not subject to similar economic or financial risks. In the same vein, commercial real estate development loans need not necessarily be grouped with residential real estate development loans, especially when the residential developer has firm, reliable purchase contracts for the sale of the homes upon completion. Even within the commercial development and construction sector, distinctions for concentration purposes may be made, when appropriate, between those loans that have firm take-out commitments and those that do not. Groups or classes of real estate loans should, of course, be combined and viewed as concentrations when they do share significant common characteristics and are similarly affected by adverse economic, financial, or business developments.

    Banking organizations should establish and adhere to policies that control "concentration risk." The lending policy should address the risk involved in various concentrations and indicate those that should be avoided or limited. However, before concentrations can be limited or reviewed, accounting systems must be in place to allow for the retrieval of information necessary to determine and monitor concentrations. The lending policy should provide for frequent monitoring and reporting of all concentrations.

    Banking organizations with asset concentrations are expected to put in place effective internal policies, systems, and controls to monitor and manage this risk. Concentrations that involve excessive or undue risks require close scrutiny and should be reduced over a reasonable period of time. When there is a need to reduce asset concentrations, banking organizations are normally expected to develop a plan that is realistic, prudent, and achievable in view of the particular circumstances and market conditions. In situations where concentration levels have built up over an extended period, it may take time—in some cases several years—to achieve a more balanced and diversified portfolio. What is critical is that adequate systems and controls are in place for reducing undue or excessive concentrations in accordance with a prudent plan, along with strong credit policies and loan-administration standards to control the risks associated with new loans, and adequate capital to protect the institution while its portfolio is being restructured.

    Institutions that have in place effective internal controls to manage and reduce concentrations over a reasonable period of time *need not* automatically refuse credit to sound borrowers simply because of the borrower's industry or geographic location. This principle applies to prudent loan renewals and rollovers, as well as to new extensions of credit that are underwritten in a sound manner.

    The purpose of a lending organization's policies should be to improve the overall quality of its portfolio. The replacement of unsound loans with sound loans can enhance the quality of a portfolio, even when concentration levels are not reduced.

12. *Refinancing or renewal of loans.* Refinancings or renewals should be structured in a manner that is consistent with sound banking, supervisory, and accounting practices, and in a manner that protects the banking organization and improves its prospects for collecting or recovering on the asset.

13. *Loan origination and loan approvals.* The policy should establish loan-origination and loan-approval procedures, both generally and by size and type of loan. The loan limitations for all lending officers should be

set accordingly. Lending limits should also be set for group authority, allowing a combination of officers or a committee to approve larger loans. Reporting procedures and the frequency of committee meetings should also be defined. The loan policy should further establish identification, review, and approval procedures for exception loans, including real estate and other loans with loan-to-value percentages in excess of supervisory limits.[4]

14. *Loan-administration procedures for loans secured by real estate.* The loan policy should establish loan-administration procedures covering documentation, disbursement, collateral administration and inspection, escrow administration, collection, loan payoffs, and loan review. Documentation procedures would specify, among other things, the types and frequency of financial statements and the requirements for verifying information provided by the borrower. They would also cover the type and frequency of collateral evaluations (appraisals and other estimates of value). In addition, loan-administration policies should address procedures for servicing and participation agreements and other loan-administration procedures such as those for claims processing (for example, seeking recovery on defaulted loans that are partially or fully guaranteed by a government entity or insurance program).
15. *Collection and foreclosure and the reporting and disclosure of delinquent obligations and charge-offs.* The lending policy should define delinquent obligations, provide guidelines on when loans are to be placed on nonaccrual or to be restructured, dictate appropriate procedures for reporting to senior management and to the directorate past-due credits, and provide appropriate guidance on the extent of disclosure of such credits. The policy should establish and require a follow-up collection procedure that is systematic and progressively stronger and should set forth guidelines (where applicable) for close surveillance by a loan work-out division. It should also address extensions and other forms of forbearance, the acceptance of deeds in lieu of foreclosure, and the timing of foreclosure. The policy must be consistent with supervisory instructions in the financial statements of condition and income for financial institutions and BHCs (bank call report and the FR Y-9C and the other FR Y-series reports). Guidelines should be established to ensure that all accounts are presented to and reviewed by management for charge-off after a stated period of delinquency. See section 2065.1 for disclosure, accounting, and reporting issues related to nonaccrual loans and restructured debt.
16. *Reserve for loan losses and provisions for loan losses.* The policy should set forth the parameters that management considers in determining an appropriate level of loan-loss reserves as well as provisions necessary to attain this level.

    Because an analysis of the allowance for loan and lease losses (ALLL) requires an assessment of the relative credit risks in the portfolio, many banking organizations, for analytical purposes, attribute portions of the ALLL to loans and other assets classified "substandard" by management or a supervisory agency. Management may do this because it believes, based on past history or other factors, that there may be unidentified losses associated with loans classified substandard in the aggregate.

    Furthermore, management may use this as an analytical approach in estimating the total amount necessary for the ALLL and in comparing the ALLL to various categories of loans over time. As a general rule, an individual loan classified substandard may remain in an accrual status as long as the regulatory reporting requirements for accrual treatment are met, even when an attribution of the ALLL has been made.
17. *Other.* The policy should address the handling of exceptions to the policy as well as provide for adherence to the policy via internal audits, centralized loan review, and/or "director's examinations." The policy should be reviewed annually to determine if it continues to be compatible with the BHC's objectives as well as market conditions.

4. For subsidiaries that are insured depository institutions, real estate loans that are in excess of supervisory loan-to-value limits are to be identified in the subsidiaries' records. The aggregate amount of these loans is to be reported quarterly to the depository institution's board of directors.

2010.2.1 UNIFORM REAL ESTATE LENDING STANDARDS

On December 23, 1992, the Board announced adoption of a uniform rule and guidelines on

real estate lending, along with the FDIC, OCC, and OTS, as mandated by section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA). The Board's Regulation H (12 C.F.R. 208, Membership of State Banking Institutions in the Federal Reserve System) was amended to implement the uniform real estate lending standards for state member banks. Although the Board did not directly apply the regulation to bank holding companies and their nonbank subsidiaries, those entities are expected to conduct and to supervise real estate lending activities prudently, consistent with safe and sound lending standards.

The agencies' regulations require that each insured depository institution adopt and maintain comprehensive written real estate lending policies appropriate to the institution and the nature and scope of its lending activities. Lending policies must be reviewed and approved by the institution's board of directors at least annually. The policies are to include standards for loan diversification and prudent underwriting as well as loan-administration procedures and documentation, approval, and reporting requirements. Depository institutions' policies are to reflect consideration of the appendix to the banking agencies' regulations, ''Interagency Guidelines for Real Estate Lending Policies.'' The guidelines are designed to help an institution formulate and maintain real estate lending policy that is appropriate to its size and the nature and scope of its operations, as required by the regulations. These guidelines are generally comparable to the inspection guidance provided in this section.

2010.2.2 LENDING STANDARDS FOR COMMERCIAL LOANS

The lending decision is properly that of the senior management and boards of directors of banking institutions, and not of their supervisory agencies. However, in fulfilling their roles, directors and senior managers have the obligation to monitor lending practices and to ensure that their policies are enforced and that lending practices generally remain within the overall ability of the institution to manage. The following subsections describe certain sound practices regarding lending standards and credit-approval processes for commercial loans.[5]

5. This guidance is derived, in part, from the June 1998 Federal Reserve supervisory staff report, ''The Significance of Recent Changes in Bank Lending Standards: Evidence from the Loan Quality Assessment Project.''

Sound lending practices address formal credit policies, formal credit-staff approval of transactions, loan-approval documentation, the use of forward-looking tools in the approval process, and management and lender information systems. In addition to evaluating adherence to these sound practices during inspections, supervisory personnel and examiners may wish to discuss these standards with loan portfolio managers at institutions where a full credit review is being performed. Senior management should be made aware of the potential for deterioration in the loan portfolio if lending discipline is not maintained, whether from inadequate assessment or communication of lending risks, incomplete adherence to prudent lending standards that reflect the risk appetite of the board of directors, or both.

Examiners should evaluate whether adequate internal oversight exists and whether institution management has timely and accurate information. As always, examiners should also discuss matters of concern with the institution and include them in their reports of inspection, even if cited practices and problem loans have not yet reached harmful or criticized levels. Such cautionary remarks help to alert institution management to potential or emerging sources of concern and may help to deter future problems. Any practices that extend beyond prudent bounds should be promptly corrected. See SR-98-18.

2010.2.2.1 Sound Practices in Loan Standards and Approval

Certain sound practices in lending can help to maintain strong credit discipline and ensure that an institution's decision to take risk in lending is well informed, balanced, and prudent. Several of these sound practices are listed and described below.

2010.2.2.1.1 Formal Credit Policies

The Federal Reserve and other supervisory authorities have long stressed the importance of formal written credit policies in a sound credit-risk-management process. Such policies can provide crucial discipline to an institution's lending process, especially when the institution's standards are under assault due to intense competition for loans. They can serve to communicate formally an institution's appetite for

credit risk in a manner that will support sound lending decisions, while focusing appropriate attention on loans being considered that diverge from approved standards.

In developing and refining loan policies, some institutions specify "guidance minimums" for financial performance ratios that apply to certain types of loans or borrowers (for example, commercial real estate). Such guidance makes explicit that loans not meeting certain financial tests (based on current performance, projected future performance, or both) should in general not be made, or alternatively should only be made under clearly specified situations. Institutions using this approach most effectively tend to avoid specifying standards for broad ranges of lending situations and instead focus on those areas of lending most vulnerable to excessive optimism, or where the institution expects loan volume to grow most significantly.

Formal policies can also provide lending discipline by clearly stating the type of covenants to be imposed for specific loan types. When designed and enforced properly, financial covenants can help significantly to reduce credit losses by communicating clear thresholds for financial performance and potentially triggering corrective or protective action at an early stage. Often, however, loan-approval documents do not describe the key financial covenants even when discussions with institutional staff disclose that such covenants are present. The staff and/or management of many institutions acknowledge that they have a "common practice" of imposing certain types of covenants on various types of loans. They indicate that such a practice is well known to lenders and others at the institution (but not articulated in their written loan policies), so that describing the actual covenants in the loan-approval document would be redundant. However, management and other approving authorities within an institution then receive no formal positive indication that "common practice" controls have been imposed and no indication of the level of financial performance that the covenants require of the borrower. As such, management and other approving authorities may be inadequately informed as to the risks and controls associated with the loan under consideration. In contrast, loan policies can create a clear expectation that (1) all key covenants should be described in loan-approval documents, (2) certain covenant types should be applied to all loans meeting certain criteria, and (3) explicit approval of any exception to these policies is necessary if such covenant requirements are to be waived.

Internal processes and requirements for underwriting decisions should be consistent with the nature, size, and complexity of the banking organization's (BO) activities. Departures from underwriting policies and standards, however, can have serious consequences for BOs of all sizes. Internal controls and credit reviews should be established and maintained to ensure compliance with those policies and procedures. When there are continued favorable economic and financial conditions, compliance monitoring of the BO's lending policies and procedures needs to be diligent to make certain that there is no undue reliance on optimistic outlooks for borrowers. Undue reliance on continued favorable economic conditions can be demonstrated by the following characteristics:

1. dependence on very rapid growth in a borrower's revenue as the "most likely" case
2. heavy reliance on favorable collateral appraisals and valuations that may not be sustainable over the longer term
3. greater willingness to make loans without scheduled amortization prior to the loan's final maturity
4. willingness to readily waive violations of key covenants, to release collateral or guarantee requirements, or even to restructure loan agreements, without corresponding concessions on the part of the borrower, on the assumption that a favorable environment will allow the borrower to recover quickly

Among the adverse effects of undue reliance on a continued favorable economy is the possibility that problem loans will not be identified properly or in a timely manner. Timely identification of problem loans is critical for providing a full awareness of the BO's risk position, informing management and directors of that position, taking steps to mitigate risk, and providing a proper assessment of the adequacy of the allowance for credit losses and capital.[6] Similarly, an overreliance on continued ready access to financial markets on favorable terms can originate from the following situations:

6. See section 2122.0 and SR-98-25, "Sound Credit-Risk Management and the Use of Internal Credit-Risk-Rating Systems at Large Banking Organizations," and section 4060.7 and SR-99-18, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles." Federal Reserve guidance on credit-risk management and mitigation covers both loans and other forms of on- and off-balance-sheet credit exposure.

1. explicit reliance on future public market debt or equity offerings, or on other sources of refinancing, as the ultimate source of principal repayment, which presumes that market liquidity and the market's appetite for such instruments will be favorable at the time that the facility is to be repaid
2. ambiguous or poorly supported analysis of the sources of repayment of the loan's principal, together with implicit reliance for repayment on some realization of the implied market valuation of the borrower (for example, through refinancing, asset sales, or some form of equity infusion), which also assumes that markets will be receptive to such transactions at the time that the facility is to be repaid
3. measuring a borrower's leverage (for example, debt-to-equity) based solely on the market capitalization of the firm without regard to "book" equity, thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed
4. more generally, extending loans with a risk profile that more closely resembles the profile of an equity investment, under circumstances that leave additional credit or default as the borrower's only resort if favorable expectations are not met

Banking organizations that become lax in adhering to established loan-underwriting policies and procedures, as a result of overreliance on favorable economic and financial market conditions, may have significant credit concentrations that are at great risk to possible economic and financial market downturns. See SR-99-23.

Some institutions have introduced credit scoring techniques into their small-business lending in an effort to improve credit discipline while allowing heavier reliance on statistical analysis rather than detailed and costly analysis of individual loans. Institutions should take care to make balanced and careful use of credit scoring technology for small-business lending and, in particular, avoid using this technology for loans or credit relationships that are large or complex enough to warrant a formal and individualized credit analysis.

In formalizing their lending standards and practices, institutions are not precluded from making loans that do not meet all written standards. Exceptions to policies, though, should be approved and monitored by management. Formal reporting that describes exceptions to loan policies, by type of exception and organizational unit, can be extremely valuable for informing management and directors of the number and nature of material deviations from the policies that they have designed and approved.

2010.2.2.1.2 Formal Credit-Staff Approval of Transactions

Credit discipline is also enhanced when experienced credit professionals are involved in the approval process and are independent of the line lending functions.[7] Such staff can play a vital role in ensuring adherence to formal policies and in ensuring that individual loan approvals are consistent with the overall risk appetite of the institution. These independent credit professionals can be most valuable if they have the authority to reject a loan that does not meet the institution's credit standards or, alternatively, if they must concur with a loan before it can be approved.

Providing credit staff with independent approval authority over lending decisions, rather than with a more traditional requirement for "consultation" between the lending function and credit staff, allows credit staff to influence outcomes on a broad and ongoing basis. This influence and indeed the ability of credit staff to reinforce lending discipline is clearly enhanced by their early involvement in negotiations with borrowers; a more traditional approach might be to only involve credit staff once the loan proposal is well developed, allowing credit staff the opportunity to have only minor influence on the outcome of negotiations except in extreme cases. Maintaining a proper balance of lending and control functions calls for a degree of partnership between line lenders and credit staff, but also requires that the independence of credit staff not be compromised by conflicting compensation policies or reporting structures.

Independent credit staff can also support sound lending practice by maintaining complete and centralized credit files that contain all key documents relevant to each loan, including complete loan-approval packages. Such files ensure that decisions are well documented and avoid

7. For example, loan officers might be compensated for bringing loan business into the institution. Independent credit professionals, however, would be another person who would not be compensated for bringing any loan business into the institution. That person would, however, serve as a quality control monitor that would have the independent authority to reject a loan(s) and to ensure that the institution's risk appetite and credit standards are not exceeded.

undue reliance on the files maintained by individual loan officers.

2010.2.2.1.3 Loan-Approval Documents

Institutions can help ensure a careful loan-approval decision by requiring thorough and standardized loan-approval documents. Thoroughness can be enhanced by requiring formal analysis of the borrower's financial condition, key characteristics and trends in the borrower's industry, information on collateral and its valuation, as well as financial analysis of the entities providing support or guarantees and formal forward-looking analyses appropriate to the size and type of loan being considered. Incorporating such elements into standardized formats and requiring that analysis and supporting commentary be complete and in adequate depth allows approving authorities access to all relevant information on the risk profile of the borrower. Loan-approval documents should also include all material details on the proposed loan agreement itself, including key financial covenants. Standardization of formats, and to some extent content, can be useful in ensuring that all relevant information is provided to management and other approving authorities in a manner that is understandable. Standard formats also draw attention to cases in which certain key information is not presented.

One area of particular interest in this regard is analysis and commentary on participations in syndicated loans. While it may be tempting to rely on the analysis and documentation provided by the agent institution to the transaction, it has been long-standing Federal Reserve policy that participating institutions should conduct their own analysis of the borrower and the transactions, particularly if the risk appetite or portfolio characteristics of the agent differs from that of the participating institution.

2010.2.2.1.4 Use of Forward-Looking Tools in the Approval Process

During continued periods of favorable economic conditions, institutions should guard against complacency and, in particular, the temptation to base expectations of a borrower's future financial performance almost exclusively on that borrower's recent performance. In making lending decisions, and in evaluating their loan portfolio, institutions should give sufficient consideration to the potential for negative events or developments that might limit the ability of borrowers to fulfill their loan obligations. Unforeseen changes in interest rates, sales revenue, and operating expenses can have material and adverse effects on the ability of many borrowers to meet their obligations. In prior decades, inadequate attention to these possibilities during the underwriting process contributed significantly to asset-quality problems in the system. Also, sudden turmoil within various countries can result in quick changes in currency valuations and economic conditions.

Examiners should evaluate the frequency and adequacy with which institutions conduct forward-looking analysis of borrower financial performance when considering an institution's credit-risk-management process. Formal use of forward-looking financial analysis in the loan-approval process, and financial projections in particular, can be important in guarding against such complacency, especially when financial institutions are competing intensely to attract borrowers. Such projections, if they include less favorable scenarios for the key determinants of the borrower's financial performance, can help to contain undue optimism and ensure that management and other approving authorities within the organization are formally presented with a robust analysis of the risks associated with each credit. They also provide credit staff and other risk-management personnel with information that is important for ensuring adherence to the institution's lending standards and overall appetite for loan risk.

The formal presentation of financial projections and/or other forms of forward-looking analyses of the borrower is important in making explicit the conditions required for a loan to perform and in communicating the vulnerabilities of the transaction to those responsible for approving loans. Analyses also provide a useful benchmark against which institutions can assess the borrower's future performance. Although it may be tempting to avoid analyzing detailed projections for smaller borrowers, such as middle-market firms, these customers may collectively represent a significant portion of the institution's loan portfolio. As such, applying formal forward-looking analysis even on a basic level assists the institution in identifying and managing the overall risk of its lending activities.

Detailed analysis of industry performance and trends can be a useful supplement to such analyses. Such projections have the most value in maintaining credit discipline when, rather than

only describing the single "most likely" scenario for future events, they characterize the kind of negative events that might impair the performance of the loan in the future.

2010.2.2.1.5 Stress Testing of the Borrower's Financial Capacity

The analysis of alternative scenarios, or "stress testing," should generally focus on the key determinants of performance for the borrower and the loan, such as the level of interest rates, the rate of sales or revenue growth, or the rate at which expense reductions can be realized. Meaningful stress testing of the prospective borrower's ability to meet its obligations is a vital part of a sound credit decision. Failure to recognize the potential for adverse events—whether specific to the borrower or its industry (for example, a change in the regulatory climate or the emergence of new competitors) or, alternatively, to the economy as a whole (for example, a recession)—can prove costly to a banking organization.

Mechanical reliance on threshold financial ratios (and the "cushion" they imply) alone is generally not sufficient, particularly for complex loans and loans to leveraged borrowers or others that must perform exceptionally well to meet their financial obligations successfully. Scenario analysis specific to the borrower, its industry, and its business plan is critical to identify the key risks of a loan. Such an analysis should have a significant influence on the decision to extend credit and, if credit is extended, on the decisions as to the appropriate loan size, repayment terms, collateral or guarantee requirements, financial covenants, and other elements of the loan's structure.

When properly conducted, meaningful stress testing can include assessing the effect the following situations or events will have on the borrower:

1. unexpected reductions in revenue growth or reversals, including shocks to revenue of the type and magnitude that would normally be experienced during a recession
2. unfavorable movements in market interest rates, especially for firms with high debt burdens
3. unplanned increases in capital expenditures due to technological obsolescence or competitive factors
4. deterioration in the value of collateral, guarantees, or other potential sources of principal repayment
5. adverse developments in key product or input markets
6. reversals in, or the borrower's reduced access to, public debt and equity markets

Proper stress testing typically incorporates an evaluation of the borrower's alternatives for meeting its financial obligations under each scenario, including asset sales, access to alternative funding or refinancing, or ability to raise new equity. In particular, the evaluation should focus not only on the borrower's ability to meet near-term interest obligations, but also on its ability to repay the principal of the obligation. See SR-99-23.

2010.2.2.1.6 Management and Lender Information

Management information systems that support the loan-approval process should clearly indicate the composition of the institution's current portfolio or exposure to allow for consideration of whether a proposed new loan—regardless of its own merits—might affect this composition sufficiently to be inconsistent with the institution's risk appetite. In particular, institutions active in commercial real estate lending should know the nature and magnitude of aggregate exposure within relevant subclasses, such as by the type of property being financed (that is, office, residential, or retail).

In addition to portfolio information, institutions should be encouraged to acquire or develop information systems that provide ready access for lenders and credit analysts to information sources that can support and enhance the financial analysis of proposed loans. Depending on the nature of an institution's borrowers, appropriate information sources may include industry financial data, economic data and forecasts, and other analytical tools such as bankruptcy scoring and default-probability models.

2010.2.3 LEVERAGED FINANCING

Leveraged financing is an important financing vehicle for mergers and acquisitions, business recapitalizations, and business expansions. These transactions are characterized by a degree of financial leverage that significantly exceeds industry norms, as measured by various debt, cash-flow, or other ratios. Consequently, lever-

aged borrowers generally have a diminished ability to respond to changing economic conditions or unexpected events, creating significant implications for an institution's overall credit-risk exposure and challenges for bank risk-management systems.

Leveraged-finance activities can be conducted in a safe and sound manner if a risk-management structure provides appropriate underwriting, pricing, monitoring, and controls. To better understand and manage the inherent risk in leveraged-finance portfolios, the board of directors and senior management must ensure that credit-analysis processes are comprehensive, monitoring is frequent, and portfolio reports are detailed.

Many leveraged transactions are underwritten with reliance on the imputed value of a business (enterprise value), which is often highly volatile. Sound valuation methodologies and ongoing stress testing and monitoring of enterprise values for these types of transactions must be emphasized. The following interagency statement provides supervisory guidance on leveraged financing, including guidance about risk rating leveraged-finance loans and how enterprise value should be evaluated in the risk-rating process. The statement is directly applicable to federally insured depository institutions. The boards of directors and senior management of financial holding companies and bank holding companies should consider the guidance as they supervise nonbanking subsidiaries engaged in leveraged-financing activities. The Federal Reserve, along with the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, issued the guidance on April 9, 2001.[8] (See SR-01-9.)

2010.2.3.1 Interagency Statement on Leveraged Financing

(The introductory paragraphs have been omitted here, as indicated by a line of asterisks. Some other wording has been slightly altered, as indicated by asterisks and brackets .)

* * * * *

8. This guidance augments previously issued supervisory statements on sound credit-risk management. See SR-99-23, "Recent Trends in Bank Lending Standards for Commercial Loans," and SR-98-18, "Lending Standards for Commercial Loans." See also sections 2010.2.2, 2010.10, and 4060.7.

Institutions participate in leveraged financing on a number of levels. In addition to providing senior secured financing, they extend credit on a subordinated basis (mezzanine financing). Institutions and their affiliates also may take equity positions in leveraged companies with direct investments through affiliated securities firms, small business investment companies (SBICs), and venture capital companies or take equity interests via warrants and other equity "kickers" received as part of a financing package. Institutions also may invest in leveraged loan funds managed by investment banking companies or other third parties. Although leveraged financing is far more prevalent in large institutions, this type of lending can be found in institutions of all sizes* * * The extent to which institutions should apply these sound practices will depend on the size and risk profile of their leveraged exposures relative to assets, earnings, and capital and the nature of their leveraged-financing activities (i.e., origination and distribution, participant, equity investor, etc.)* * *

2010.2.3.1.1 Risk-Management Guidelines

Institutions substantively engaged in leveraged financing are expected to adequately risk-rate, track, and monitor these transactions and to maintain policies specifying conditions that would require a change in risk rating, accrual status, loss recognition, or reserves. In general, the risk-management framework for leveraged finance is no different from that which should be applied to all lending activities. However, because of the potential higher level of risk, the degree of oversight should be more intensive.

2010.2.3.1.1.1 Loan Policy

The loan policy should specifically address the institutions' leveraged-lending activities by including—

- a definition of leveraged lending;
- an approval policy that requires sufficient senior-level oversight;
- pricing policies that ensure a prudent tradeoff between risk and return; and
- a requirement for action plans whenever cash flow, asset-sale proceeds, or collateral values decline significantly from projections. Action plans should include remedial initiatives and triggers for rating downgrades, changes to accrual status, and loss recognition.

2010.2.3.1.1.2 Underwriting Standards

Either the loan policy or separate underwriting guidelines should prescribe specific underwriting criteria for leveraged financing. The standards should avoid compromising sound banking practices in an effort to broaden market share or realize substantial fees. The policy should—

- describe appropriate leveraged loan structures;
- require reasonable amortization of term loans (i.e., allow a moderate time period to realize the benefit of synergies or augment revenues and institute meaningful repayment);
- specify collateral policies including acceptable types of collateral, loan-to-value limits, collateral margins, and proper valuation methodologies;
- establish covenant requirements, particularly minimum interest and fixed-charge coverage and maximum leverage ratios;
- describe how enterprise values and other intangible business values may be used; and
- establish minimum documentation requirements for appraisals and valuations, including enterprise values and other intangibles.

2010.2.3.1.1.3 Limits

Leveraged-finance and other loan portfolios with above-average default probabilities tend to behave similarly during an economic or sectoral downturn. Consequently, institutions should take steps to avoid undue concentrations by setting limits consistent with their appetite for risk and their financial capacity. Institutions should ensure that they monitor and control as separate risk concentrations those loan segments most vulnerable to default. Institutions may wish to identify such concentrations by the leveraged characteristics of the borrower, by the institution's internal-risk grade, by particular industry or other factors that the institution determines are correlated with an above-average default probability. In addition, sublimits may be appropriate by collateral type, loan purpose, industry, secondary sources of repayment, and sponsor relationships. Institutions should also establish limits for the aggregate number of policy exceptions.

2010.2.3.1.1.4 Credit Analysis

Effective management of leveraged-financing risk is highly dependent on the quality of analysis during the approval process and after the loan is advanced. At a minimum, analysis of leveraged-financing transactions should ensure that—

- cash-flow analyses do not rely on overly optimistic or unsubstantiated projections of sales, margins, and merger and acquisition synergies;
- projections provide an adequate margin for unanticipated merger-related integration costs;
- projections are stress-tested for one or two downside scenarios;
- transactions are reviewed quarterly to determine variance from financial plans, the risk implications thereof, and the accuracy of risk ratings and accrual status;
- collateral valuations are derived with a proper degree of independence and consider potential value erosion;
- collateral-liquidation and asset-sale estimates are conservative;
- potential collateral shortfalls are identified and factored into risk-rating and accrual decisions;
- contingency plans anticipate changing conditions in debt or equity markets when exposures rely on refinancing or recapitalization; and
- the borrower is adequately protected from interest-rate and foreign-exchange risk.

2010.2.3.1.1.5 Enterprise Value

Enterprise value is often relied upon in the underwriting of leveraged loans to evaluate the feasibility of a loan request, determine the debt-reduction potential of planned asset sales, assess a borrower's ability to access the capital markets, and to provide a secondary source of repayment. Consideration of enterprise value is appropriate in the credit-underwriting process. However, enterprise value and other intangible values can be difficult to determine, are frequently based on projections, and may be subject to considerable change. Consequently, reliance upon them as a secondary source of repayment can be problematic.

Because enterprise value is commonly derived from the cash flows of a business, it is closely correlated with the primary source of repayment. This interdependent relationship between primary and secondary repayment sources increases the risk in leveraged financing, especially when credit weaknesses develop.

Events or changes in business conditions that negatively affect a company's cash flow will also negatively affect the value of the business, simultaneously eroding both the lender's primary and secondary source of repayment. Consequently, lenders that place undue reliance upon enterprise value as a secondary source of repayment or that utilize unrealistic assumptions to determine enterprise value are likely to approve unsound loans at origination or experience outsize losses upon default.

It is essential that institutions establish sound valuation methodologies for enterprise value, apply appropriate margins to protect against potential changes in value, and conduct ongoing stress testing and monitoring.

2010.2.3.1.1.6 Rating Leveraged-Finance Loans

Institutions need thoroughly articulated policies that specify requirements and criteria for risk-rating transactions, identifying loan impairment, and recognizing losses. Such specificity is critical for maintaining the integrity of an institution's risk-management system. Institutions' internal rating systems should incorporate both the probability of default and loss given default in their ratings to ensure that the risk of the borrower and the risk of the transaction structure itself are clearly evaluated. This is particularly germane to leverage-finance-transactions structures, which in many recent cases have resulted in large losses upon default.

In cases where a borrower's condition or future prospects have significantly weakened, leveraged-finance loans will likely merit a substandard classification based on the existence of well-defined weaknesses. If such weaknesses appear to be of a lasting nature and it is probable that a lender will be unable to collect all principal and interest owed, the loan should be placed on nonaccrual and will likely have a doubtful component. Such loans should be reviewed for impairment in accordance with FAS 114, "Accounting by Creditors for Impairment of a Loan."

If the primary source of repayment is inadequate and a loan is considered collateral-dependent, it is generally inappropriate to consider enterprise value unless the value is well supported. Well-supported enterprise values may be evidenced by a binding purchase and sale agreement with a qualified third party or through valuations that fully consider the effect of the borrower's distressed circumstances and potential changes in business and market conditions. For such borrowers, where a portion of the loan is not protected by pledged assets or a well-supported enterprise value, examiners will generally classify the unprotected portion of the loan doubtful or loss.

In addition, institutions need to ensure that the risks in leveraged-lending activities are fully incorporated in the allowance-for-loan-and-lease-loss and capital-adequacy analysis. For allowance purposes, leverage exposures should be taken into account either through analysis of the expected losses from the discrete portfolio or as part of an overall analysis of the portfolio utilizing the institution's internal risk grades or other factors. At the transaction level, exposures heavily reliant on enterprise value as a secondary source of repayment should be scrutinized to determine the need for and adequacy of specific allocations.

2010.2.3.1.1.7 Problem-Loan Management

For adversely rated borrowers and other high-risk borrowers who significantly depart from planned cash flows, asset sales, collateral values, or other important targets, institutions should formulate individual action plans with critical objectives and time frames. Actions may include working with the borrower for an orderly resolution while preserving the institution's interests sale in the secondary market, and liquidation. Regardless of the action, examiners and bankers need to ensure such credits are reviewed regularly for risk-rating accuracy, accrual status, recognition of impairment through specific allocations, and charge-offs.

2010.2.3.1.1.8 Portfolio Analysis

Higher-risk credits, including leveraged-finance transactions, require frequent monitoring by banking organizations. At least quarterly, management and the board of directors should receive comprehensive reports about the characteristics and trends in such exposures. These reports at a minimum should include—

- total exposure and segment exposures, including subordinated debt and equity holdings, compared to established limits;
- risk-rating distribution and migration data;
- portfolio performance—noncompliance with covenants, restructured loans, delinquencies,

nonperforming assets, and impaired loans; and
- compliance with internal procedures and the aggregate level of exceptions to policy and underwriting standards.

Institutions with significant exposure levels to higher-risk credits should consider additional reports covering—

- collateral composition of the portfolio, e.g. percentages supported by working assets, fixed assets, intangibles, blanket liens, and stock of borrower's operating subsidiaries;
- unsecured or partially secured exposures, including potential collateral shortfalls caused by defaults that trigger pari passu [equable] collateral treatment for all lender classes;
- absolute amount and percentage of the portfolio dependent on refinancing, recapitalization, asset sales, and enterprise value;
- absolute amounts and percentages of scheduled and actual annual portfolio amortizations; and
- secondary-market pricing data and trading volume for loans in the portfolio.

2010.2.3.1.1.9 Internal Controls

Institutions engaged in leveraged finance need to ensure their internal-review function is appropriately staffed to provide timely, independent assessments of leveraged credits. Reviews should evaluate risk-rating integrity, valuation methodologies, and the quality of risk management. Because of the volatile nature of these credits, portfolio reviews should be conducted on at least an annual basis. For many institutions, the risk characteristics of the leveraged portfolio, such as high reliance on enterprise value, concentrations, adverse risk-rating trends or portfolio performance, will dictate more frequent reviews.

2010.2.3.1.2 Distributions

Asset sales, participations, syndication, and other means of distribution are critical elements in the rapid growth of leveraged financing. [Lead and purchasing institutions are expected] to adopt formal policies and procedures addressing the distribution and acquisition of leveraged-financing transactions. The policies should include—

- procedures for defining, managing, and accounting for distribution fails;
- identification of any sales made with recourse and procedures for fully reflecting the risk of any such sales;
- a process to ensure that purchasers are provided with timely, current financial information;
- a process to determine the portion of a transaction to be held in the portfolio and the portion to be held for sale;
- limits on the length of time transactions can be held in the held-for-sale account and policies for handling items that exceed those limits;
- prompt recognition of losses in market value for loans classified as held-for-sale; and
- procedural safeguards to prevent conflicts of interest for both bank and affiliated securities firms.

2010.2.3.1.3 Participations Purchased

Institutions purchasing participations and assignments in leveraged finance must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include requirements for—

- obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter;
- obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, UCC searches, and other relevant documents;
- carefully monitoring the borrower's performance throughout the life of the loan; and
- establishing appropriate risk-management guidelines as described in this [statement].

2010.2.3.1.4 Process to Identify Potential Conflicts

Examiners should determine whether an institution's board of directors and management have established policies for leveraged finance that minimize the risks posed by potential legal issues and conflicts of interest.

2010.2.3.1.4.1 Conflicts of Interest

When a banking company plays multiple roles in leveraged finance, the interests of different customers or the divisions of the institution may conflict. For example, a lender may be reluctant to employ an aggressive collection strategy with a problem borrower because of the potential impact on the value of the organization's equity interest. A lender may also be pressured to provide financial or other privileged client information that could benefit an affiliated equity investor. Institutions should develop appropriate policies to address potential conflicts of interest. Institutions should also track aggregate totals for borrowers and sponsors to which it has both a lending and equity relationship. Appropriate limits should be established for such relationships.

2010.2.3.1.4.2 Securities Laws

Equity interests and certain debt instruments used in leveraged lending may constitute "securities" for the purposes of federal securities laws. When securities are involved, institutions should ensure compliance with applicable securities law requirements, including disclosure and regulatory requirements.[9] Institutions should also establish procedures to restrict the internal dissemination of material nonpublic information about leveraged-finance transactions.

2010.2.3.1.4.3 Compliance Function

The legal and regulatory issues raised by leveraged transactions are numerous and complex. To ensure that potential conflicts are avoided and laws and regulations are adhered to, an independent compliance function should review all leveraged-financing activity.

* * * * *

9. Institutions also should ensure that any acquired equity positions are consistent with any applicable equity ownership restrictions imposed by federal and state laws, such as those in the Bank Holding Company Act or Federal Reserve Act. Institutions need to take special care to aggregate all the equity positions held throughout the entire organization, including those held in all banking and nonbanking subsidiaries. [footnote added]

2010.2.3.1.5 Examination Risk-Rating Guidance for Leveraged Financing

When evaluating individual borrowers, examiners should pay particular attention to—

- the overall performance and profitability of a borrower and its industry over time, including periods of economic or financial adversity;
- the history and stability of a borrower's market share, earnings, and cash flow, particularly over the most recent business cycle and last economic downturn; and
- the relationship between a borrowing company's projected cash flow and debt-service requirements and the resulting margin of debt-service coverage.

2010.2.3.1.5.1 Cash Flow/Debt-Service Coverage

Particular attention should be paid to the adequacy of the borrower's cash flow and the reasonableness of projections. Before entering into a leveraged-financing transaction, bankers should conduct an independent, realistic assessment of the borrower's ability to achieve the projected cash flow under varying economic and interest-rate scenarios. This assessment should take into account the potential effects of an economic downturn or other adverse business conditions on the borrower's cash flow and collateral values. Normally bankers and examiners should adversely rate a credit if material questions exist as to the borrower's ability to achieve the projected necessary cash flows, or if orderly repayment of the debt is in doubt. Credits with only minimal cash flow for debt service are usually subject to an adverse rating.

2010.2.3.1.5.2 Enterprise Value

Many leveraged-financing transactions rely on "enterprise value" as a secondary source of repayment. Most commonly, enterprise value is based on a "going concern" assumption and derived from some multiple of the expected income or cash flow of the firm. The methodology and assumptions underlying the valuation should be clearly disclosed, well supported, and understood by appropriate decision makers and risk-oversight units. Examiners should ensure that the valuation approach is appropriate for the company's industry and condition.

Enterprise value is often viewed as a secondary source of repayment and as such would be

relied upon under stressful conditions. In such cases the assumptions used for key variables such as cash flow, earnings, and sale multiples should reflect those adverse conditions. These variables can have a high degree of uncertainty—sales and cash-flow projections may not be achieved; comparable sales may not be available; changes can occur in a firm's competitive position, industry outlook, or the economic environment. Because of these uncertainties, changes in the value of a firm's assets need to be tested under a range of stress scenarios, including business conditions more adverse than the base-case scenario. Stress testing of enterprise values and their underlying assumptions should be conducted upon origination of the loan and periodically thereafter, incorporating the actual performance of the borrower and any adjustments to projections. The bank should in all cases perform its own discounted cash-flow analysis to validate "enterprise value" implied by proxy measures such as multiples of cash flow, earnings, or sales.

Finally, it must be recognized that valuations derived with even the most rigorous valuation procedures are imprecise and may not be realized when needed by an institution. Therefore, institutions relying on enterprise value or illiquid and hard-to-value collateral must have lending policies that provide for appropriate loan-to-value ratios, discount rates, and collateral margins.

2010.2.3.1.5.3 Deal Sponsors

Deal sponsors can be an important source of financial support for a borrower that fails to achieve cash-flow projections. However, support from this source should only be considered positively in a risk-rating decision when the sponsor has a history of demonstrated support as well as the economic incentive, capacity, and stated intent to continue to support the transaction. Even with capacity and a history of support, a sponsor's potential contributions should not mitigate criticism unless there is clear reason to believe it is in the best interests of the sponsor to continue that support or unless there is a formal guarantee.

2010.2.4 CREDIT-RISK MANAGEMENT GUIDANCE FOR HOME EQUITY LENDING

The federal bank and thrift regulatory agencies collectively issued the following interagency guidance on May 16, 2005. The guidance is intended to promote sound credit-risk management practices at banking organizations[10] that have home equity lending programs, including open-end home equity lines of credit (HELOCs) and closed-end home equity loans (HELs). Banking organizations' credit-risk management practices for home equity lending need to keep pace with the rapid growth in home equity lending and should emphasize compliance with sound underwriting standards and practices.

The risk factors listed below, combined with an inherent vulnerability to rising interest rates, suggest that banking organizations need to fully recognize the risk embedded in their home equity portfolios. Following are the specific product, risk-management, and underwriting risk factors and trends that deserve scrutiny:

1. interest-only features that require no amortization of principal for a protracted period
2. limited or no documentation of a borrower's assets, employment, and income (known as "low do" or "no doc" lending)
3. higher loan-to-value (LTV) and debt-to-income (DTI) ratios
4. lower credit-risk scores for underwriting home equity loans;
5. greater use of automated valuation models (AVMs) and other collateral-evaluation tools for the development of appraisals and evaluations
6. an increase in the number of transactions generated through a loan broker or other third party

Home equity lending can be conducted in a safe and sound manner if pursued with the appropriate risk-management structure, including adequate allowances for loan and lease losses and appropriate capital levels. Sound practices call for fully articulated policies that address marketing, underwriting standards, collateral-valuation management, individual-account and portfolio management, and servicing.

10. The agencies are 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. The interagency guidance frequently uses the term "financial institutions." Bank holding companies have financial institutions and various credit-extending nonbanking subsidiaries. The combined entity is being referred to in this guidance as a banking organization.

Banking organizations should ensure that risk-management practices keep pace with the growth and changing risk profile of home equity portfolios. Management should actively assess a portfolio's vulnerability to changes in consumers' ability to pay and the potential for declines in home values. Active portfolio management is especially important for banking organizations that project or have already experienced significant growth or concentrations, particularly in higher-risk products such as high-LTV, "low doc" or "no doc," interest-only, or third-party-generated loans. (See SR-05-11.)

2010.2.4.1 Credit-Risk Management Systems

2010.2.4.1.1 Product Development and Marketing

In the development of any new product offering, product change, or marketing initiative, management should have a review and approval process that is sufficiently broad to ensure compliance with the banking organization's internal policies and applicable laws and regulations[11] and to evaluate the credit, interest-rate, operational, compliance, reputation, and legal risks. In particular, risk-management personnel should be involved in product development, including an evaluation of the targeted population and the product(s) being offered. For example, material changes in the targeted market, origination source, or pricing could have a significant impact on credit quality and should receive senior management approval.

When HELOCs or HELs are marketed or closed by a third party, banking organizations should have standards that provide assurance that the third party also complies with applicable laws and regulations, including those on marketing materials, loan documentation, and closing procedures. (For further details on agent relationships, see section 2010.2.4.1.3, "Third-Party Originations.") Finally, management should have appropriate monitoring tools and management information systems (MIS) to measure the performance of various marketing initiatives, including offers to increase a line, extend the interest-only period, or adjust the interest rate or term.

2010.2.4.1.2 Origination and Underwriting

All relevant risk factors should be considered when establishing product offerings and underwriting guidelines. Generally, these factors should include a borrower's income and debt levels, credit score (if obtained), and credit history, as well as the loan size, collateral value (including valuation methodology), lien position, and property type and location.

Consistent with the Federal Reserve's regulations on real estate lending standards, prudently underwritten home equity loans should include an evaluation of a borrower's capacity to adequately service the debt.[12] Given the home equity products' long-term nature and the large credit amount typically extended to a consumer, an evaluation of repayment capacity should consider a borrower's income and debt levels and not just a credit score.[13] Credit scores are based upon a borrower's historical financial performance. While past performance is a good indicator of future performance, a significant change in a borrower's income or debt levels can adversely alter the borrower's ability to pay. How much verification these underwriting factors require will depend upon the individual loan's credit risk.

HELOCs generally do not have interest-rate caps that limit rate increases.[14] Rising interest rates could subject a borrower to significant payment increases, particularly in a low-interest-rate environment. Therefore, underwriting standards for interest-only and variable-rate HELOCs should include an assessment of the borrower's ability to amortize the fully drawn line over the loan term and to absorb potential increases in interest rates.

11. Applicable laws include the Federal Trade Commission Act; the Equal Credit Opportunity Act (ECOA); the Truth in Lending Act (TILA), including the Home Ownership and Equity Protection Act (HOEPA); the Fair Housing Act; the Real Estate Settlement Procedures Act (RESPA); and the Home Mortgage Disclosure Act (HMDA), as well as applicable state consumer protection laws.

12. On December 23, 1992, the Federal Reserve announced the adoption of uniform rules on real estate lending standards and issued the Interagency Guidelines for Real Estate Lending Policies. See subsection 2010.2.1. See also 12 C.F.R., section 208.51 and appendix C.

13. The Interagency Guidelines Establishing Standards for Safety and Soundness also call for documenting the source of repayment and assessing the ability of the borrower to repay the debt in a timely manner. See 12 C.F.R. 208, appendix D-1.

14. While there may be periodic rate increases, the lender must state in the consumer credit contract the maximum interest rate that may be imposed during the term of the obligation. See 12 C.F.R. 226.30(b).

2010.2.4.1.3 Third-Party Originations

Banking organizations often use third parties, such as mortgage brokers or correspondents, to originate loans. When doing so, they should have strong control systems to ensure the quality of originations and compliance with all applicable laws and regulations, and to help prevent fraud.

Brokers are firms or individuals, acting on behalf of either the banking organization or the borrower, who match the borrower's needs with institutions' mortgage-origination programs. Brokers take applications from consumers. Although they sometimes process the application and underwrite the loan to qualify the application for a particular lender, they generally do not use their own funds to close loans. Whether brokers are allowed to process and perform any underwriting will depend on the relationship between the banking organization and the broker. For control purposes, the banking organization should retain appropriate oversight of all critical loan-processing activities, such as verification of income and employment and independence in the appraisal and evaluation function.

Correspondents are financial companies that usually close and fund loans in their own name and subsequently sell them to a lender. Banking organizations commonly obtain loans through correspondents and, in some cases, delegate the underwriting function to the correspondent. In delegated underwriting relationships, a banking organization grants approval to a correspondent financial company to process, underwrite, and close loans according to the delegator's processing and underwriting requirements and is committed to purchase those loans. The delegating banking organization should have systems and controls to provide assurance that the correspondent is appropriately managed, is financially sound, and provides mortgages that meet the banking organization's prescribed underwriting guidelines and that comply with applicable consumer protection laws and regulations. A quality-control unit or function in the delegating banking organization should closely monitor the quality of loans that the correspondent underwrites. Monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities.

Both brokers and correspondents are compensated based upon mortgage-origination volume and, accordingly, have an incentive to produce and close as many loans as possible. Therefore, banking organizations should perform comprehensive due diligence on third-party originators prior to entering a relationship. In addition, once a relationship is established, the banking organization should have adequate audit procedures and controls to verify that the third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.[15] Monitoring the quality of loans by origination source, and uncovering such problems as early payment defaults and incomplete packages, enables management to know if third-party originators are producing quality loans. If ongoing credit or documentation problems are discovered, the banking organization should take appropriate action against the third party, which could include terminating its relationship with the third party.

2010.2.4.1.4 Collateral-Valuation Management

Competition, cost pressures, and advancements in technology have prompted banking organizations to streamline their appraisal and evaluation processes. These changes, coupled with banking organizations underwriting to higher LTVs, have heightened the importance of strong collateral-valuation management policies, procedures, and processes.

Banking organizations should have appropriate collateral-valuation policies and procedures that ensure compliance with the Federal Reserve's appraisal regulations[16] and the Interagency Appraisal and Evaluation Guidelines (the guidelines).[17] In addition, the banking organization should—

1. establish criteria for determining the appropriate valuation methodology for a particular transaction, based on the risk in the transaction and loan portfolio (For example, higher-

15. In addition, a banking organization that purchases loans subject to TILA's rules for HELs with high rates or high closing costs (loans covered by HOEPA) can incur assignee liability unless the banking organization can reasonably show that it could not determine the transaction was a loan covered by HOEPA. Also, the nature of its relationship with brokers and correspondents may have implications for liability under ECOA, and for reporting responsibilities under HMDA.

16. 12 C.F.R. 208, subpart E, and 12 C.F.R. 225, subpart G.

17. See SR-94-55, dated October 27, 1994. These revised guidelines include the June 1994 amendments. See also section 2231.0.15, appendix A.

risk transactions or nonhomogeneous property types should be supported by more-thorough valuations. The banking organization should also set criteria for determining the extent to which an inspection of the collateral is necessary.)
2. ensure that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation
3. implement policies and controls to preclude "value shopping" (Use of several valuation tools may return different values for the same property. These differences can result in systematic overvaluation of properties if the valuation choice becomes driven by the highest property value. If several different valuation tools or AVMs are used for the same property, the banking organization should adhere to a policy for selecting the most reliable method, rather than the highest value.)
4. require sufficient documentation to support the collateral valuation in the appraisal or evaluation

2010.2.4.1.5 AVMs

When AVMs are used to support evaluations or appraisals, the banking organization should validate the models on a periodic basis to mitigate the potential valuation uncertainty in the model. As part of the validation process, the banking organization should document the validation's analysis, assumptions, and conclusions. The validation process includes back-testing a representative sample of the valuations against market data on actual sales (where sufficient information is available). The validation process should cover properties representative of the geographic area and property type for which the tool is used.

Many AVM vendors, when providing a value, will also provide a "confidence score," which usually relates to the accuracy of the value provided. Confidence scores, however, come in many different formats and are calculated based on differing scoring systems. Banking organizations that use AVMs should have an understanding of how the model works as well as what the confidence scores mean. Confidence levels should be established by the banking organization that are appropriate for the risk in a given transaction or group of transactions.

When tax-assessment valuations are used as a basis for the collateral valuation, the banking organization should be able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value as part of the validation process.

2010.2.4.1.6 Account Management

Since HELOCs often have long-term, interest-only payment features, banking organizations should have risk-management techniques that identify higher-risk accounts and adverse changes in account risk profiles, thereby enabling management to implement timely preventive action (e.g., freezing or reducing lines). Further, a banking organization should have risk-management procedures to evaluate and approve additional credit on an existing line or extending the interest-only period. Account-management practices should be appropriate for the size of the portfolio and the risks associated with the types of home equity lending.

Effective account-management practices for large portfolios or portfolios with high-risk characteristics include—

1. periodically refreshing credit-risk scores on all customers;
2. using behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
3. periodically assessing utilization rates;
4. periodically assessing payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the line to keep payments current;
5. monitoring home values by geographic area; and
6. obtaining updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

The frequency of these actions should be commensurate with the risk in the portfolio. Banking organizations should conduct annual credit reviews of HELOC accounts to determine whether the line of credit should be continued, based on the borrower's current financial condition.[18]

18. Under the Federal Reserve's risk-based capital guidelines, an unused HELOC commitment with an original matu-

When appropriate, banking organizations should refuse to extend additional credit or reduce the credit limit of a HELOC, bearing in mind that under Regulation Z such steps can be taken only in limited circumstances. These include, for example, when the value of the collateral declines significantly below the appraised value for purposes of the HELOC, default of a material obligation under the loan agreement, or deterioration in the borrower's financial circumstances.[19] In order to freeze or reduce credit lines due to deterioration in a borrower's financial circumstances, two conditions must be met: (1) there must be a "material" change in the borrower's financial circumstances and (2) as a result of this change, the banking organization must have a reasonable belief that the borrower will be unable to fulfill the plan's payment obligations.

Account-management practices that do not adequately control authorizations and provide for timely repayment of over-limit amounts may significantly increase a portfolio's credit risk. Authorizations of over-limit home equity lines of credit should be restricted and subject to appropriate policies and controls. A banking organization's practices should require over-limit borrowers to repay in a timely manner the amount that exceeds established credit limits. Management information systems should be sufficient to enable management to identify, measure, monitor, and control the unique risks associated with over-limit accounts.

2010.2.4.1.7 Portfolio Management

Banking organizations should implement an effective portfolio credit-risk management process for their home equity portfolios that includes the following.

2010.2.4.1.7.1 Policies

The Federal Reserve's real estate lending standards regulations require that a banking organization's real estate lending policies be consistent with safe and sound banking practices and that the banking organization's board of directors review and approve these policies at least annually. Before implementing any changes to policies or underwriting standards, management should assess the potential effect on the banking organization's overall risk profile, which would include the effect on concentrations, profitability, and delinquency and loss rates. The accuracy of these estimates should be tested by comparing them with actual experience.

2010.2.4.1.7.2 Portfolio Objectives and Risk Diversification

Effective portfolio management should clearly communicate portfolio objectives, such as growth targets, utilization, rate-of-return hurdles, and default and loss expectations. For banking organizations with significant concentrations of HELs or HELOCs, limits should be established and monitored for key portfolio segments, such as geographic area, loan type, and higher-risk products. When appropriate, consideration should be given to the use of risk mitigants, such as private mortgage insurance, pool insurance, or securitization. As the portfolio approaches concentration limits, the banking organization should analyze the situation sufficiently to enable the banking organization's board of directors and senior management to make a well-informed decision to either raise concentration limits or pursue a different course of action.

Effective portfolio management requires an understanding of the various risk characteristics of the home equity portfolio. To gain this understanding, a banking organization should analyze the portfolio by segment, using criteria such as product type, credit-risk score, DTI, LTV, property type, geographic area, collateral-valuation method, lien position, size of credit relative to prior liens, and documentation type (such as "no doc" or "low doc").

2010.2.4.1.7.3 Management Information Systems

By maintaining adequate credit MIS, a banking organization can segment loan portfolios and accurately assess key risk characteristics. The MIS should also provide management with sufficient information to identify, monitor, measure, and control home equity concentrations.

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rity of one year or more may be allocated a zero percent conversion factor if the banking organization conducts at least an annual credit review and is able to unconditionally cancel the commitment (i.e., prohibit additional extensions of credit, reduce the credit line, and terminate the line) to the full extent permitted by relevant federal law. See 12 C.F.R. 208, appendix A, III.D.4., and 12 C.F.R. 225, appendix A, III.D.4.

19. Regulation Z does not permit these actions to be taken in circumstances other than those specified in the regulation. See 12 C.F.R. 226.5b(f)(3)(vi)(A)–(F).

Banking organizations should periodically assess the adequacy of their MIS in light of growth and changes in their appetite for risk. For banking organizations with significant concentrations of HELs or HELOCs, MIS should include, at a minimum, reports and analysis of the following:

1. production and portfolio trends by product, loan structure, originator channel, credit score, LTV, DTI, lien position, documentation type, market, and property type
2. delinquency and loss-distribution trends by product and originator channel with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, DTI)
3. vintage tracking
4. the performance of third-party originators (brokers and correspondents)
5. market trends by geographic area and property type to identify areas of rapidly appreciating or depreciating housing values

2010.2.4.1.7.4 Policy and Underwriting-Exception Systems

Banking organizations should have a process for identifying, approving, tracking, and analyzing underwriting exceptions. Reporting systems that capture and track information on exceptions, both by transaction and by relevant portfolio segments, facilitate the management of a portfolio's credit risk. The aggregate data is useful to management in assessing portfolio risk profiles and monitoring the level of adherence to policy and underwriting standards by various origination channels. Analysis of the information may also be helpful in identifying correlations between certain types of exceptions and delinquencies and losses.

2010.2.4.1.7.5 High-LTV Monitoring

To clarify the real estate lending standards regulations and interagency guidelines, the agencies issued Guidance on High Loan-To-Value (HLTV) Residential Real Estate Lending (the HLTV guidance) in October 1999. The HLTV guidance clarified the Interagency Real Estate Lending Guidelines and the supervisory loan-to-value limits for loans on one- to four-family residential properties. Banking organizations are expected to ensure compliance with the supervisory loan-to-value limits of the Interagency Real Estate Lending Guidelines. The HLTV guidance outlines controls that the banking organizations should have in place when engaging in HLTV lending. Banking organizations should accurately track the volume of HLTV loans, including HLTV home equity and residential mortgages, and report the aggregate of such loans to the banking organization's board of directors. Specifically, banking organizations are reminded that:

1. Loans in excess of the supervisory LTV limits should be identified in the banking organization's records. The aggregate of high-LTV one-to four-family residential loans should not exceed 100 percent of the banking organization's total capital.[20] Within that limit, high-LTV loans for properties other than one- to four-family residential properties should not exceed 30 percent of capital.
2. In calculating the LTV and determining compliance with the supervisory LTVs, the banking organization should consider all senior liens. All loans secured by the property and held by the banking organization are reported as an exception if the combined LTV of a loan and all senior liens on an owner-occupied one- to four-family residential property equals or exceeds 90 percent and if there is no additional credit enhancement in the form of either mortgage insurance or readily marketable collateral.
3. For the LTV calculation, the loan amount is the legally binding commitment (that is, the entire amount that the banking organization is legally committed to lend over the life of the loan).
4. All real–estate secured loans in excess of supervisory LTV limits should be aggregated and included in a quarterly report for the banking organization's board of directors.

Certain insurance products help banking organizations mitigate the credit risks of HLTV

20. For purposes of the Interagency Real Estate Lending Standards Guidelines, high-LTV one- to four-family residential property loans include (1) a loan for raw land zoned for one- to four-family residential use with an LTV ratio greater than 65 percent; (2) a residential land development loan or improved lot loan with an LTV greater than 75 percent; (3) a residential construction loan with an LTV ratio greater than 85 percent; (4) a loan on non-owner occupied one- to four-family residential property with an LTV greater than 85 percent; and (5) a permanent mortgage or home equity loan on an owner-occupied residential property with an LTV equal to or exceeding 90 percent without mortgage insurance, readily marketable collateral, or other acceptable collateral.

residential loans. Insurance policies that cover a "pool" of loans can be an efficient and effective credit-risk management tool. But if a policy has a coverage limit, the coverage may be exhausted before all loans in the pool mature or pay off. The Federal Reserve considers pool insurance to be a sufficient credit enhancement to remove the HLTV designation in the following circumstances: (1) the policy is issued by an acceptable mortgage insurance company, (2) it reduces the LTV for each loan to less than 90 percent, and (3) it is effective over the life of each loan in the pool.

2010.2.4.1.7.6 Stress Testing for Portfolios

Banking organizations with home equity concentrations as well as higher-risk portfolios are encouraged to perform sensitivity analyses on key portfolio segments. This type of analysis identifies possible events that could increase risk within a portfolio segment or for the portfolio as a whole. Banking organizations should consider stress tests that incorporate interest-rate increases and declines in home values. Since these events often occur simultaneously, the agencies recommend testing for these events together. Banking organizations should also periodically analyze markets in key geographic areas, including identified "soft" markets. Management should consider developing contingency strategies for scenarios and outcomes that extend credit risk beyond internally established risk tolerances. These contingency plans might include increased monitoring, tightening underwriting, limiting growth, and selling loans or portfolio segments.

2010.2.4.1.8 Operations, Servicing, and Collections

Effective procedures and controls should be maintained for such support functions as perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes. Credit-risk management should oversee these support functions to ensure that operational risks are properly controlled.

2010.2.4.1.8.1 Lien Recording

Banking organizations should take appropriate measures to safeguard their lien position. They should verify the amount and priority of any senior liens prior to closing the loan. This information is necessary to determine the loan's LTV ratio and to assess the credit support of the collateral. Senior liens include first mortgages, outstanding liens for unpaid taxes, outstanding mechanic's liens, and recorded judgments on the borrower.

2010.2.4.1.8.2 Problem-Loan Workouts and Loss-Mitigation Strategies

Banking organizations should have established policies and procedures for problem loan workouts and loss-mitigation strategies. Policies should be in accordance with the requirements of the FFIEC's Uniform Retail Credit Classification and Account Management Policy, issued June 2000 (see SR-00-8 and section 2241.0) and should, at a minimum, address the following:

1. circumstances and qualifying requirements for various workout programs including extensions, re-ages, modifications, and re-writes (Qualifying criteria should include an analysis of a borrower's financial capacity to service the debt under the new terms.)
2. circumstances and qualifying criteria for loss-mitigating strategies, including foreclosure
3. appropriate MIS to track and monitor the effectiveness of workout programs, including tracking the performance of all categories of workout loans (For large portfolios, vintage delinquency and loss tracking also should be included.)

While banking organizations are encouraged to work with borrowers on a case-by-case basis, a banking organization should not use workout strategies to defer losses. Banking organizations should ensure that credits in workout programs are evaluated separately for the allowance for loan and lease losses (ALLL), because such credits tend to have higher loss rates than other portfolio segments.

2010.2.4.1.9 Secondary-Market Activities

More banking organizations are issuing HELOC mortgage-backed securities (i.e., securitizing HELOCs). Although such secondary-market activities can enhance credit availability and a banking organization's profitability, they also pose certain risk-management challenges. A

banking organization's risk-management systems should address the risks of HELOC securitizations.[21]

2010.2.4.1.10 Portfolio Classifications, Allowance for Loan and Lease Losses, and Capital

The FFIEC's Uniform Retail Credit Classification and Account Management Policy governs the classification of consumer loans and establishes general classification thresholds that are based on delinquency. Banking organizations and the Federal Reserve's examiners have the discretion to classify entire retail portfolios, or segments thereof, when underwriting weaknesses or delinquencies are pervasive and present an excessive level of credit risk. Portfolios of high-LTV loans to borrowers who exhibit inadequate capacity to repay the debt within a reasonable time may be subject to classification.

Banking organizations should establish appropriate ALLL and hold capital commensurate with the riskiness of their portfolios. In determining the ALLL adequacy, a banking organization should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for its HELOC portfolio. Those banking organizations engaging in programmatic subprime home equity lending or banking organizations that have higher-risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy.[22]

2010.2.5 INSPECTION OBJECTIVES

Loan Administration

1. To determine if the parent's loan policies are adequate in relation to the responsibilities it has for the supervision of its credit-extending subsidiaries and whether those policies are consistent with safe and sound lending practices.
2. To determine if internal and external factors (for example, the size and financial condition of the credit-extending subsidiary, the size and expertise of its staff, avoidance of or control over credit concentrations, market conditions, and statutory and regulatory compliance) are considered in formulating and monitoring the organization's loan policies and strategic plan.
3. To determine if the loan policy is being monitored and complied with.
4. To establish whether the loan policy ensures sound assessments of the value of real estate and other collateral.

Lending Standards for Commercial Loans

1. To focus on and evaluate the strength of the credit-risk management process.
2. To determine whether the bank holding company has formal credit policies that (1) provide clear guidance on its appetite for credit risk and (2) support sound lending decisions.
3. To determine whether experienced credit professionals who are independent of line lending functions provide adequate internal control in the loan-approval process.
4. To evaluate whether loan-approval documents provide internal approving authorities and management with sufficient information on the risks of loans being considered, and that the information is in a clear and understandable format.
5. To evaluate whether forward-looking analysis tools are being adequately and appropriately used as part of the loan-approval process.
6. To determine whether credit-risk management information systems provide adequate information to management and lenders.
7. To incorporate the examiner's evaluation of the bank holding company's adherence to sound practices into the overall assessment of credit-risk management.
8. To be alert to indications of insufficiently rigorous risk assessment at banking organizations, particularly inadequate stress testing and excessive reliance on strong economic conditions and robust financial markets to support a borrower's capacity to service its debts.

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21. See SR-02-16, "Interagency Questions and Answers on Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitizations," (see also section 4060.3.5.3.2.3) and the risk management and capital adequacy of exposures arising from secondary-market credit activities discussion in SR-97-21 (see also section 2129.05).

22. See the January 2001 Interagency Expanded Guidance for Subprime Lending Programs (section 2128.08) for supervisory expectations regarding risk-management processes, the allowance for loan and lease losses, and capital adequacy for banking organizations engaging in subprime-lending programs.

9. To be attentive in reviewing a banking organization's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead to delayed recognition of emerging weaknesses in some loans.
10. To ascertain whether the banking organization has relied, to a significant and undue extent, on favorable assumptions about borrowers or the economy and financial markets. If so, to carefully consider downgrading, under the applicable supervisory rating framework, a banking organization's risk-management, management, and/or asset-quality ratings and, if deemed sufficiently significant to the banking organization, its capital adequacy rating.
11. To determine if the banking organization's loan-review activities or other internal control and risk-management processes have been weakened by staff turnover, failure to commit sufficient resources, inadequate training, and reduced scope or by less-thorough internal loan reviews. To incorporate such findings into the determination of supervisory ratings.

Credit-Risk Management for Home Equity Lending

1. To determine if the banking organization has an appropriate review and approval process for new product offerings, product changes, and marketing initiatives.
2. To ascertain whether the banking organization has appropriate control procedures for third parties that generate loans on its behalf and if the control procedures comply with the laws and regulations that are applicable to the organization.
3. To determine if the banking organization has given full recognition to the risks embedded in its home equity lending.
4. To determine whether the banking organization's risk-management practices have kept pace with the growth and changing risk profile of its home equity portfolios and whether underwriting standards have eased.
5. To determine whether the loan policy—
   a. ensures prudent underwriting standards for home equity lending, including standards to ensure that a thorough evaluation of a borrower's capacity to service the debt is conducted (that is, the banking organization is not relying solely on the borrower's credit score);
   b. provides risk-management safeguards for potential declines in home values;
   c. ensures that the standards for interest-only and variable-rate home equity lines of credit (HELOCs) include an assessment of a borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates; and
   d. provides appropriate collateral-valuation policies and procedures and provides for the use and validation of automated valuation models.

2010.2.6 INSPECTION PROCEDURES

Loan Administration

1. Obtain an organizational chart and determine the various levels of responsibility and job functions of individuals involved with the lending function.
2. Obtain and review the BHC's loan policy; determine if the policy contains the appropriate components, as summarized in this section. Determine how the policy is communicated to subsidiaries. Also determine whether the loan policy reflects the December 1992 uniform interagency real estate lending standards and guidelines as they apply to subsidiary depository institutions.
3. Obtain a copy of the most recent management reports concerning the quality of loans and other aspects of the loan portfolio (delinquency list, concentrations, yield analysis, loan-distribution lists, watch loan reports, charge-off reports, participation listings, internal and external audit reports, etc.). Determine the scope and sufficiency of the work performed by any committees related to the lending function. Determine if the information provided to the directorate and senior management is sufficient for them to make judgments about the quality of the portfolio and to determine appropriate corrective action.
4. Determine if an internal process has been established for the review and approval of loans that do not conform to internal lending policy. Establish whether such loans are supported by written documentation that clearly states all the relevant credit factors that culminated in the underwriting decision. Determine if exception loans of a sig-

nificant size are reported to the board of directors of the subsidiary or to the holding company.

5. Review internal and external audit reports and bank examination reports for critical comments concerning loan-policy exceptions and administration. Determine whether action was taken in response to any identified exceptions. Determine who is responsible for follow-up and what the time frames are; seek rationale if no action was taken or if the action taken was half-hearted.
6. Review the organization's financial statements, the bank Call Reports, and the BHC FR Y-series reports submitted to the Federal Reserve. Determine whether reporting is accurate and disclosure is sufficient to indicate the organization's financial position and the nature of its loan portfolios, including nonaccrual loans.
7. When reviewing lending policies, ascertain whether—
   a. the loan policies facilitate extensions of credit to sound borrowers and facilitate the workout of problem loans, and
   b. the loan policies control and reduce concentration risk by placing emphasis on effective internal policies, systems, and controls to monitor the risk.
8. Through interviews with, or review of reports submitted by, the internal auditor, lending officers, loan-review personnel, and senior management, (1) evaluate the effectiveness of the BHC's self-monitoring of adherence to loan policy, (2) determine how changes to the loan policy occur, (3) determine how loans made in contradiction to the loan policy are explained, and (4) determine the various circumstances involving levels of approval and what specific consideration occurs at these levels.
9. Presuming the inspection is concurrent with a bank's primary regulator, coordinate, on a random basis, the selection of loans subject to classification. Determine whether they conform to loan policy.
10. Review management's policies and procedures for their determination of an appropriate level of loan-loss reserves.
11. On the "Policies and Supervision" or an equivalent page of the inspection report, evaluate the BHC's oversight regarding effective lending policy and procedures.

Lending Standards for Commercial Loans

1. Review formal credit policies for clear articulation of current lending standards, including—
   a. a description of the characteristics of acceptable loans and (if applicable) "guidance" minimum financial ratios,
   b. standards for the types of covenants to be imposed for specific loan types, and
   c. the treatment and reporting of policy exceptions, both for individual loans and the entire portfolio.
2. Evaluate the role played by independent credit staff in loan approvals and, in particular, whether these credit professionals are adequately experienced, are independent of line lending functions, and have authority to reject loans either because of specific exceptions to policy or because the loan does not meet the institution's credit-risk appetite.
3. Review written policies and determine operating practice in preparing loan-approval documents to evaluate whether sufficient information is provided on the characteristics and risks of loans being considered, and whether such information is provided clearly and can be easily understood.
4. Based on written policies and review of operating practice, evaluate whether loans being considered are evaluated not only on the basis of the borrower's current performance but on the basis of forward-looking analysis of the borrower.
   a. Determine whether financial projections or other forward-looking tools are an integral part of the preapproval analysis and loan-approval documents.
   b. Determine the extent to which alternative or "downside" scenarios are identified, considered, and analyzed in the loan-approval process.
5. Review credit-risk management information systems and reports to determine whether they provide adequate information to management and lenders about—
   a. the composition of the institution's current portfolio or exposure, to allow for consideration of whether proposed loans might affect this composition sufficiently to be inconsistent with the institution's risk appetite, and
   b. data sources, analytical tools, and other information to support credit analysis.
6. When appropriate, coordinate or conduct sufficient loan reviews and transaction testing in the lending function to accurately determine the quality of loan portfolios and other credit

exposures. If deficiencies in lending practices or credit discipline are indicated as a result of the preexamination risk assessment, the inspection, or bank or other examinations, arrange for the commitment of sufficient supervisory resources to conduct in-depth reviews, including transaction testing, that are adequate to ensure that the Federal Reserve achieves a full understanding of the nature, scope, and implications of the deficiencies.

7. When reviewing loans, lending policies, and lending practices—
   a. observe and analyze loan-pricing policies and practices to determine whether the institution may be unduly weighting the short-term benefit of retaining or attracting new customers through price concessions, while not giving sufficient consideration to potential longer-term consequences;
   b. be alert for indications of insufficiently rigorous risk assessment, in particular (1) excessive reliance on strong economic conditions and robust financial markets to support the capacity of borrowers to service their debts and (2) inadequate stress testing;
   c. be attentive in reviewing an institution's assessment and monitoring of credit risk to ensure that undue reliance on favorable conditions does not lead that institution to delay recognition of emerging weaknesses in some loans or to lessen staff resources assigned to internal loan review;[23] and
   d. give careful consideration to downgrading, under the applicable supervisory rating framework, a banking organization's risk-management, management, and/or asset-quality ratings and its capital adequacy rating (if sufficiently significant) when there is significant and undue reliance on favorable assumptions about borrowers or the economy and financial markets, or when that reliance has slowed the recognition of loan problems.
8. Discuss matters of concern with the senior management and the board of directors of the bank holding company and report those areas of concern on core page 1, "Examiner's Comments and Matters Requiring Special Board Attention."

23. Examiners should recognize that an increase in classified or special-mention loans is not per se an indication of lax lending standards. Examiners should review and consider the nature of these increases and the surrounding circumstances in reaching their conclusions about the asset quality and risk management of an institution.

Credit-Risk Management for Home Equity Lending

1. Review the credit policies for home equity lending to determine if the underwriting standards address all relevant risk factors (that is, an analysis of a borrower's income and debt levels, credit score, and credit history versus the loan's size, the collateral value (including valuation methodology), the lien position, and the property type and location.
2. Determine whether the banking organization's underwriting standards include—
   a. a properly documented evaluation of the borrower's financial capacity to adequately service the debt;
   b. an adequately documented evaluation of the borrower's ability to (1) amortize the fully drawn line of credit over the loan term and (2) absorb potential increases in interest rates for interest-only and variable-rate HELOCs.
3. Assess the reasonableness and adequacy of the analyses and methodologies underlying the banking organization's evaluation of borrowers.
4. If the organization uses third parties to originate home equity loans, find out—
   a. if the organization delegates the underwriting function to a broker or correspondent;
   b if the banking organization's internal controls for delegated underwriting are adequate;
   c. whether the banking organization retains appropriate oversight of all critical loan-processing activities, such as verification of income and employment and the independence of the appraisal and evaluation function;
   d. if there are adequate systems and controls to ensure that a third-party originator is appropriately managed, is financially sound, provides mortgages that meet the banking organization's prescribed underwriting guidelines, and adheres to applicable consumer protection laws and regulations;
   e. if the banking organization has a quality-control unit or function that closely monitors (monitoring activities should include post-purchase underwriting reviews and ongoing portfolio-performance-management activities) the

quality of loans that the third party underwrites; and
f. whether the banking organization has adequate audit procedures and controls to verify that third parties are not being paid to generate incomplete or fraudulent mortgage applications or are not otherwise receiving referral or unearned income or fees contrary to RESPA prohibitions.

5. Evaluate the adequacy of the banking organization's collateral-valuation policies and procedures. Ascertain whether the organization—
   a. establishes criteria for determining the appropriate valuation methodology for a particular transaction (based on the risk in the transaction and loan portfolio);
   b. sets criteria for determining when a physical inspection of the collateral is necessary;
   c. ensures that an expected or estimated value of the property is not communicated to an appraiser or individual performing an evaluation;
   d. implements policies and controls to preclude "value shopping";
   e. requires sufficient documentation to support the collateral valuation in the appraisal or evaluation.
6. If the banking organization uses automated valuation models (AVMs) to support evaluations or appraisals, find out if the organization—
   a. periodically validates the models, to mitigate the potential valuation uncertainty in the model;
   b. adequately documents the validation's analysis, assumptions, and conclusions;
   c. back-tests a representative sample of evaluations and appraisals supporting loans outstanding; and
   d. evaluates the reasonableness and adequacy of its procedures for validating AVMs.
7. If tax-assessment valuations are used as a basis for collateral valuation, ascertain whether the banking organization is able to demonstrate and document the correlation between the assessment value of the taxing authority and the property's market value, as part of the validation process.
8. Review the risk- and account-management procedures. Verify that the procedures are appropriate for the size of the banking organization's loan portfolio, as well as for the risks associated with the types of home equity lending conducted by the organization.
9. If the banking organization has large home equity loan portfolios or portfolios with high-risk characteristics, determine if the organization—
   a. periodically refreshes credit-risk scores on all customers;
   b. uses behavioral scoring and analysis of individual borrower characteristics to identify potential problem accounts;
   c. periodically assesses utilization rates;
   d. periodically assesses payment patterns, including borrowers who make only minimum payments over a period of time or those who rely on the credit line to keep payments current;
   e. monitors home values by geographic area; and
   f. obtains updated information on the collateral's value when significant market factors indicate a potential decline in home values, or when the borrower's payment performance deteriorates and greater reliance is placed on the collateral.

   Determine that the frequency of these actions is commensurate with the risk in the portfolio.
10. Verify that annual credit reviews of home equity line of credit (HELOC) accounts are conducted. Verify if the reviews of HELOC accounts determine whether the line of credit should be continued, based on the borrower's current financial condition.
11. Determine that authorizations of over-limit home equity lines of credit are restricted and subject to appropriate policies and controls.
    a. Verify that the banking organization requires over-limit borrowers to repay, in a timely manner, the amount that exceeds established credit limits.
    b. Evaluate the sufficiency of management information systems (MIS) that enable management to identify, measure, monitor, and control the risks associated with over-limit accounts.
12. Verify that the organization's real estate lending policies are consistent with safe and sound banking practices and that its board of directors reviews and approves the policies at least annually.
13. Determine whether the MIS—
    a. allows for the segmentation of the loan portfolios;

   b. accurately assesses key risk characteristics; and
   c. provides management with sufficient information to identify, monitor, measure, and control home equity concentrations.
14. Determine whether management periodically assesses the adequacy of its MIS, in light of growth and changes in the banking organization's risk appetite.
15. If the banking organization has significant concentrations of home equity loans (HELs) or HELOCs, determine if the MIS includes, at a minimum, reports and analysis of the following:
   a. production and portfolio trends by product, loan structure, originator channel, credit score, loan to value (LTV), debt to income (DTI), lien position, documentation type, market, and property type
   b. the delinquency and loss-distribution trends by product and originator channel, with some accompanying analysis of significant underwriting characteristics (such as credit score, LTV, or DTI)
   c. vintage tracking
   d. the performance of third-party originators (brokers and correspondents)
   e. market trends by geographic area and property type, to identify areas of rapidly appreciating or depreciating housing values
16. Determine whether the banking organization accurately tracks the volume of high-LTV (HLTV) loans, including HLTV home equity and residential mortgages, and if the organization reports the aggregate of these loans to its board of directors.
17. Determine whether loans in excess of the supervisory LTV limits are identified as high-LTV loans in the banking organization's records. Determine whether the organization reports, on a quarterly basis, the dollar value of such loans to its board of directors.
18. Find out whether the organization has purchased insurance products to help mitigate the credit risks of its HLTV residential loans. If a policy has a coverage limit, determine whether the coverage may be exhausted before all loans in the pool mature or pay off.
19. Determine whether the organization's credit-risk management function oversees the support function(s). Evaluate the effectiveness of controls and procedures over staff persons responsible who are responsible for perfecting liens, collecting outstanding loan documents, obtaining insurance coverage (including flood insurance), and paying property taxes.
20. Determine whether policies and procedures have been established for home equity problem-loan workouts and loss-mitigation strategies.

The System's ability to evaluate the effectiveness of a company's supervision and control of subsidiary investment activities can be strengthened not only by evaluating the parent's role in light of efficiency and operating performance, but also by evaluating the quality of control and supervision. In order to assess quality there must be a standard or measuring block against which a company's policies can be evaluated. By establishing the minimum areas that a company's policies should address with respect to subsidiary investments, a standard is created which can evaluate the quality of company's control and supervision of that activity. The examiner needs to make a qualitative assessment of the parent's supervision and control of subsidiary investment activities.

2010.3.1 INSPECTION OBJECTIVES

1. Determine if the parent's investment policy is adequate for the organization.
2. Determine if the investment policy is being complied with.

2010.3.2 INSPECTION PROCEDURES

1. Determine whether the management has developed a flow chart on investment authorization procedures sufficiently detailed to assure that the execution of transactions precludes the ability to circumvent policy directives.
2. Determine whether all investment policies appear to be adequately tailored to fit the business needs of each subsidiary. Review the methods and/or process through which prior approval of new activities and investments in new instruments is granted.
3. Determine whether the boards of directors and the management of subsidiaries appear to be sufficiently involved in their respective roles to assure that the performance of fiduciary responsibilities of each appears adequate.
4. Assess the adequacy of the level of management expertise in relation to its involvement in various investment activities.
5. Evaluate the reasonableness of investment activity initiated to achieve corporate objectives in light of its potential impact on the risk exposure of subsidiaries.
6. Assess the adequacy of investment policy directives in regard to the required maintenance of adequate recordkeeping systems at subsidiaries.
7. Evaluate policy directives regarding the appropriateness of accounting practices in regard to transactions involving investment participations, swaps, other transfers of investments as well as specialized investment activities.
8. Evaluate whether investment policies adequately provide for the maintenance of a stable income stream at bank subsidiaries as well as the parent company level.
9. Determine whether investment policy directives adequately address statutory limitations, particularly those involving intercompany transactions.
10. Evaluate the effectiveness of the bank holding company's audit function in assuring that investment policies and directives are adhered to at each corporate level.

This section emphasizes the importance of integrating subsidiaries into a consolidated plan, the essential elements of the planning process, and the ultimate accountability of the board of directors of the holding company. As a minimum, the parent's consolidated plan should include the following ten elements:

1. *All plans should address a long-range goal or focus, intermediate term objectives, and short-term budgets.* A long-range focus is particularly important during a changing environment and during expansions of the organization. Long-range plans generally are broad with a service or customer orientation and market share emphasis. These plans provide the entire organization with a consistent direction and facilitate changes in the organization arising from environmental changes. Intermediate goals generally are narrower in scope. Short-term budgets are generally developed at the subsidiary level; however, they are subject to review and revision by the parent in an effort to maintain consistency throughout the organization.

2. *The planning process should be formalized.* A long-range focus, intermediate term objectives, and budgets should be written and adopted by the parent's board of directors to insure centralized accountability.

3. *Plans should be consistent and interrelated over the differing time periods.* For example, budgets should be consistent with long-range goals—the implementation of a short-term, high return orientation may be inconsistent with a long-term goal of increasing market share, or short-term compensation plans may be disfunctional in the long run.

4. *A consolidated plan should increase the consistency of goals among differing subsidiaries and the parent.* The long-range goals, intermediate term objectives, and short term goals and objectives should be periodically reviewed, preferably, annually, by the BHC's board of directors. A consolidated plan should reduce unnecessary internal competition.

5. *A consolidated plan should facilitate the allocation of resources throughout the organization.* This is particularly important when the parent is providing most, or all, of the short-term funds and long-term capital. As the parent has an awareness of all subsidiaries, it can better allocate funds and personnel to areas where they will be utilized most effectively.

6. *Plans should be formulated with an awareness to possible weaknesses and recognition to areas likely to be influenced by environmental change.* For these areas, flexibility should exist for contingency plans.

7. *Methods should be determined, in the plan, to monitor and evaluate compliance with the plan.*

8. *The consolidated plan should have a measurable aspect to determine whether budgets, objectives, and goals are being met.* If they are not met, determination as to the controllability of variances should be ascertained.

9. *Plans and goals must continually be evaluated to determine whether accomplishing the goal results in the desired and expected outcome.* For example, the desired outcome may be to increase net income by granting loans with higher interest rates and above normal risk. The granting of such loans may result in a need to increase the provision for loan losses, thus causing a decrease in earnings.

10. *Plans should be flexible enough to remain effective in a volatile environment.* If plans are too rigid, they may become disfunctional if the environment changes and actually constrain an organization's ability to react. On the other hand, flexible goals and plans should enhance an organization's ability to compete by providing the entire organization with a fluid consistent direction.

2010.4.1 INSPECTION OBJECTIVES

1. To determine if the board of directors at the parent company is cognizant of and performing its duties and responsibilities.
2. To determine if the level of supervision over subsidiaries is both adequate and beneficial.
3. To evaluate the consolidated plan for consistency, controls, and effectiveness.
4. To ascertain if the board of directors of the parent company is making judgments and decisions based on adequate information flowing from the management and financial reporting systems of the organization.

2010.4.2 INSPECTION PROCEDURES

1. Evaluate the participation by the board of directors of the parent company in giving overall direction to the organization.
2. Obtain and evaluate descriptions of all im-

portant management and financial policies, procedures, and practices.

3. Determine if contradictions or ‘‘conflicts’’ between expressed and unexpressed strategies and between long-term and short-term goals exist. Also determine that goals are consistent with concern over safety and soundness.

4. Determine whether the planning process is sufficiently flexible and if contingency plans exist.

5. Spell out the lines of authority associated with the planning process.

6. Determine the degree of control exercised by the parent company over the entire organization.

7. Test compliance with policies at all levels.

2010.5.1 BACKGROUND INFORMATION ON ENVIRONMENTAL LIABILITY

Banking organizations are increasingly becoming exposed 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. It 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 statutes, as well as 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.[1]

While the superfund statute was enacted a decade ago, 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. In this connection, recent court decisions have 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. This has led to uncertainty on the part of banking organizations as to how to best 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 of. . . .”[2] 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 interest in the vessel or facility.”[3] However, this exception has not provided banking organizations with an effective “safe harbor” because recent court decisions have worked to limit the application of this exemption. Specifically, courts have 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 have 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 have 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.

2010.5.2 OVERVIEW OF ENVIRONMENTAL HAZARDS

Environmental risk can be characterized as adverse consequences resulting from having gen-

1. Resource Conservation and Recovery Act of 1986 (RCRA).
2. CERCLA, Section 107(a).
3. CERCLA, Section 101(20)(A)..

erated 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 1950's to the late 1970's. Asbestos has since been 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.

2010.5.3 IMPACT ON BANKING ORGANIZATIONS

Banking organizations may encounter losses arising from environmental liability in several ways. The greatest risk to banking organizations, 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 banking organization is found to be a responsible party under CERCLA, the banking organization 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 the banking organization, could be forced to pay the full cost of any clean-up. Of course, the banking organization may attempt to recover such costs from the borrower, or 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 contamination in situations where the banking organization:

- 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 existing, or acquires (by merger or acquisition), subsidiaries involved in activities that might result in a finding of environmental liability;
- Owns existing, 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 having underground storage tanks once operated. Also, premises or other real estate owned could be contaminated by asbestos requiring costly clean-up or abatement.

A more common situation encountered by banking organizations has been where real prop-

erty 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 banking organization 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 banking organization 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 banking organizations 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 banking organization'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 prior to 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 which occurred prior to their owning or using real estate.

2010.5.4 PROTECTION AGAINST ENVIRONMENTAL LIABILITY

Banking organizations 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. The following discussion briefly describes methods currently being employed by banking organizations and others to minimize potential environmental liability.

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 as well as 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—prior to taking title to real property—foreclosures. Banking organizations 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, but 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 which could be considered active participation in the management of the borrower's business, and therefore subject the bank to potential liability, include, but are not limited to:

- having bank employees as members of the borrower's board of directors or actively participating in board decisions;
- assisting in day-to-day management and operating decisions; and
- 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 banking organizations 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 is accomplished by interviewing persons familiar with present and past 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, subsurface soil samples, or 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 banking organization, 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.

2010.5.5 CONCLUSION

Potential environmental liability can touch on a great number of loans to borrowers in many industries or localities. Moreover, nonlending activities as well as corporate affiliations can lead to environmental liability depending upon the nature of the these activities and the degree of participation that the parent exercises in the operations of its subsidiaries. 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.

2010.5.6 INSPECTION OBJECTIVES

1. To determine whether adequate safeguards and controls have been established to limit exposure to potential environmental liability.
2. To determine whether the banking organization has identified specific credits and any lending and other banking and nonbanking activities that expose the organization to environmental liability.

2010.5.7 INSPECTION PROCEDURES

1. Review loan policies and procedures and establish whether these and other adequate safeguards and controls have been established to avoid or mitigate potential environmental liability.[4] In performing this task, ascertain whether:
   a. an environmental policy statement has been adopted;
   b. training programs are being conducted so that lending personnel are aware of environmental liability issues and are able to identify borrowers with potential problems;
   c. guidelines and procedures have been established for dealing with new borrowers and real property offered as collateral.
   d. the lending policies and procedures and other safeguards, including those to assess and control environmental liability, may not be construed as actively participating in the management of day-to-day operations of borrowers' businesses.

4. Refer to SR-91-20.

2. When reviewing individual credits determine whether the loan policy has been complied with in regard to a borrower's activities or industry that is associated with hazardous substances or environmental liability.

3. Ascertain whether appropriate periodic analysis of potential environmental liability is conducted.

Such analysis should be more rigorous as the risk of hazardous substance contamination increases. The following are examples of types of analyses and procedures that should be progressively considered as the risk of environmental liability increases:

- Environmental review—screening of the borrower's activities by lending personnel or real estate appraisers for potential environmental problems (using questionnaires, interviews, or observations).

  Review procedures might include a survey of past ownership and uses of the property, a property inspection, a review of adjacent or contiguous parcels of property, a review of company records for past use or disposal of hazardous materials, and a review of any relevant Environmental Protection Agency records.
- Environmental assessment—structured analysis by a *qualified* individual that identifies the borrower's past practices, regulatory compliance, and potential future problems. This analysis would include reviewing relevant documents, visiting and inspecting the site, and, in some cases, performing limited tests.
- Environmental audit—a professional environmental engineer performs a similar structured analysis as previously indicated for "environmental assessments," however, more comprehensive testing might involve collecting and analyzing air samples, surface soil samples, subsurface soil samples, or drilling wells to sample ground water.

4. Determine whether existing loans are reviewed internally to identify credits having potential environmental problems.

5. Review recordkeeping procedures and determine whether there is documentation as to the due diligence efforts taken at the time of making loans or acquiring real property.

6. Review loan agreements to determine if warranties, representations, and indemnifications have been included in loan agreements designed to protect the banking organization 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.)

7. For situations involving potential environmental liability arising from a banking organization's nonlending activities, verify that similar policies and procedures are in place.[5]

5. A banking organization's policies and procedures relating to environmental liability should apply to nonlending situations where appropriate. For example, banking organizations engaged in trust activities or contemplating a merger or acquisition should evaluate the possibility of existing or subsequent environmental liability arising from these activities.

The Board of Governors of the Federal Reserve System, along with the other federal banking regulators, issued an interagency statement on February 15, 1994, that provides comprehensive guidance on retail sales of nondeposit investment products occurring on or from depository institution premises. The interagency statement unifies pronouncements previously issued by the banking agencies that addressed various aspects of retail sales programs involving mutual funds, annuities, and other nondeposit investment products.

The interagency statement was made effective immediately and applies to all depository institutions, including state member banks and the U.S. branches and agencies of foreign banks, supervised by the Federal Reserve. The policy statement does not apply directly to bank holding companies. However, the board of directors and management of bank holding companies should consider and administer the provisions of the statement with regard to the holding company's supervision of its banking and thrift subsidiaries that offer such products to retail customers. Reserve Bank examiners will continue to review nondeposit investment product sales activities during examinations of institutions engaging in such activities on their premises, either directly or through a third party or an affiliate. The review process will consist of, at a minimum, an assessment of whether the interagency statement is being followed, particularly with regard to the nature and sufficiency of an institution's disclosures, the separation of functions, and the training of personnel involved with the sales of mutual funds and other nondeposit products. (See SR-94-11.)

The following is the text of the interagency policy statement, further clarified by a September 12, 1995, joint interpretation (SR-95-46). Section numbers have been added for reference.

2010.6.1 INTERAGENCY STATEMENT ON RETAIL SALES OF NONDEPOSIT INVESTMENT PRODUCTS

Insured depository institutions have expanded their activities in recommending or selling such products. Many depository institutions are providing these services at the retail level, directly or through various types of arrangements with third parties.

Sales activities for nondeposit investment products should ensure that customers for these products are clearly and fully informed of the nature and risks associated with these products. In particular, where nondeposit investment products are recommended or sold to retail customers, depository institutions should ensure that customers are fully informed that the products—

- are not insured by the FDIC;
- are not deposits or other obligations of the institution and are not guaranteed by the institution; and
- are subject to investment risks, including possible loss of the principal invested.

Moreover, sales activities involving these investment products should be designed to minimize the possibility of customer confusion and to safeguard the institution from liability under the applicable antifraud provisions of the federal securities laws, which, among other things, prohibit materially misleading or inaccurate representations in connection with the sale of securities.

The four federal banking agencies—the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision—issued the statement to provide uniform guidance to depository institutions engaging in these activities.[1]

2010.6.1.1 Scope

This statement applies when retail recommendations or sales of nondeposit investment products are made by—

- employees of the depository institution;
- employees of a third party, which may or may

1. Each of the four banking agencies has in the past issued guidelines addressing various aspects of the retail sale of nondeposit investment products. OCC Banking Circular 274 (July 19, 1993), FDIC Supervisory Statement FIL-71-93 (October 8, 1993), former Federal Reserve letters SR-93-35 (June 17, 1993) and SR-91-14 (June 6, 1991), and OTS Thrift Bulletin 23-1 (Sept. 7, 1993). This statement is intended to consolidate and make uniform the guidance contained in the various existing statements of each of the agencies, all of which are superseded by this statement.

Some of the banking agencies have adopted additional guidelines covering the sale of certain specific types of instruments by depository institutions, i.e., obligations of the institution itself or of an affiliate of the institution. These guidelines remain in effect except where clearly inapplicable.

not be affiliated with the institution,[2] occurring on the premises of the institution (including telephone sales or recommendations by employees or from the institution's premises and sales or recommendations initiated by mail from its premises); and

- sales resulting from a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

Retail sales include (but are not limited to) sales to individuals by depository institution personnel or third-party personnel conducted in or adjacent to the institution's lobby area. Sales of government or municipal securities away from the lobby area are not subject to the interagency statement. The statement also applies to sales activities of an affiliated stand-alone broker-dealer resulting from a referral of retail customers from the depository institution to the broker-dealer.

These guidelines generally do not apply to the sale of nondeposit investment products to nonretail customers, such as sales to fiduciary accounts administered by an institution.[3] The disclosures provided for by the interagency statement, however, should be provided to customers of fiduciary accounts where the customer directs investments, such as self-directed IRA accounts. Such disclosures need not be made to customers acting as professional money managers. Fiduciary accounts administered by an affiliated trust company on the depository institution's premises should be treated as fiduciary accounts of the institution. However, as part of its fiduciary responsibility, an institution should take appropriate steps to avoid potential customer confusion when providing nondeposit investment products to the institution's fiduciary customers.

2010.6.1.2 Adoption of Policies and Procedures

2010.6.1.2.1 Program Management

A depository institution involved in the activities described above for the sale of nondeposit investment products to its retail customers should adopt a written statement that addresses the risks associated with the sales program and contains a summary of policies and procedures outlining the features of the institution's program and addressing, at a minimum, the concerns described in this statement. The written statement should address the scope of activities of any third party involved, as well as the procedures for monitoring compliance by third parties in accordance with the guidelines below. The scope and level of detail of the statement should appropriately reflect the level of the institution's involvement in the sale or recommendation of nondeposit investment products. The institution's statement should be adopted and reviewed periodically by its board of directors. Depository institutions are encouraged to consult with legal counsel with regard to the implementation of a nondeposit investment product sales program.

The institution's policies and procedures should include the following:

Compliance procedures. The procedures for ensuring compliance with applicable laws and regulations and consistency with the provisions of this statement.

Supervision of personnel involved in sales. A designation by senior managers of specific individuals to exercise supervisory responsibility for each activity outlined in the institution's policies and procedures.

Types of products sold. The criteria governing the selection and review of each type of product sold or recommended.

Permissible use of customer information. The procedures for the use of information regarding the institution's customers for any purpose in connection with the retail sale of nondeposit investment products.

Designation of employees to sell investment products. A description of the responsibilities of those personnel authorized to sell nondeposit investment products and of other personnel who may have contact with retail customers concerning the sales program, and a description of any

2. This statement does not apply to the subsidiaries of insured state nonmember banks, which are subject to separate provisions, contained in 12 C.F.R. 337.4, relating to securities activities. For OTS-regulated institutions that conduct sales of nondeposit investment products through a subsidiary, these guidelines apply to the subsidiary. 12 C.F.R. 545.74 also applies to such sales. Branches and agencies of U.S. foreign banks should follow these guidelines with respect to their nondeposit investment sales programs.

3. Restrictions on a national bank's use as fiduciary of the bank's brokerage service or other entity with which the bank has a conflict of interest, including purchases of the bank's proprietary and other products, are set out in 12 C.F.R. 9.12. Similar restrictions on transactions between funds held by a federal savings association as fiduciary and any person or organization with whom there exists an interest that might affect the best judgment of the association acting in its fiduciary capacity are set out in 12 C.F.R. 550.10.

appropriate and inappropriate referral activities and the training requirements and compensation arrangements for each class of personnel.

2010.6.1.2.2 Arrangements with Third Parties

If a depository institution directly or indirectly, including through a subsidiary or service corporation, engages in activities as described above under which a third party sells or recommends nondeposit investment products, the institution should, prior to entering into the arrangement, conduct an appropriate review of the third party. The institution should have a written agreement with the third party that is approved by the institution's board of directors. Compliance with the agreement should be periodically monitored by the institution's senior management. At a minimum, the written agreement should—

- describe the duties and responsibilities of each party, including a description of permissible activities by the third party on the institution's premises; terms as to the use of the institution's space, personnel, and equipment; and compensation arrangements for personnel of the institution and the third party;
- specify that the third party will comply with all applicable laws and regulations, and will act consistently with the provisions of this statement and, in particular, with the provisions relating to customer disclosures;
- authorize the institution to monitor the third party and periodically review and verify that the third party and its sales representatives are complying with its agreement with the institution;
- authorize the institution and the appropriate banking agency to have access to such records of the third party as are necessary or appropriate to evaluate such compliance;
- require the third party to indemnify the institution for potential liability resulting from actions of the third party with regard to the investment product sales program; and
- provide for written employment contracts, satisfactory to the institution, for personnel who are employees of both the institution and the third party.

2010.6.1.3 General Guidelines

2010.6.1.3.1 Disclosures and Advertising

The banking agencies believe that recommending or selling nondeposit investment products to retail customers should occur in a manner that ensures that the products are clearly differentiated from insured deposits. Conspicuous and easy-to-comprehend disclosures concerning the nature of nondeposit investment products and the risk inherent in investing in these products are one of the most important ways of ensuring that the differences between nondeposit products and insured deposits are understood.

2010.6.1.3.1.1 Content and Form of Disclosure

Disclosures with respect to the sale or recommendation of these products should, at a minimum, specify that the product is—

- not insured by the FDIC;
- not a deposit or other obligation of, or guaranteed by, the depository institution; and
- subject to investment risks, including possible loss of the principal amount invested.

The written disclosures described above should be conspicuous and presented in a clear and concise manner. Depository institutions may provide any additional disclosures that further clarify the risks involved with particular nondeposit investment products.

2010.6.1.3.1.2 Timing of Disclosure

The minimum disclosures should be provided to the customer—

- orally during any sales presentation;
- orally when investment advice concerning nondeposit investment products is provided;
- orally and in writing prior to or at the time an investment account is opened to purchase these products; and
- in advertisements and other promotional materials, as described below.

A statement, signed by the customer, should be obtained at the time such an account is opened, acknowledging that the customer has received and understands the disclosures. Third-party vendors not affiliated with the depository institution need not make the minimum disclosures on confirmations and account statements that contain the name of the depository institu-

tion as long as the name of the depository institution is there only incidentally and with a valid business purpose, and as long as it is clear on the face of the document that the broker-dealer, and not the depository institution, has sold the nondeposit investment products. For investment accounts established prior to the issuance of these guidelines, the institution should consider obtaining such a signed statement at the time of the next transaction.

Confirmations and account statements for such products should contain at least the minimum disclosures if the confirmations or account statements contain the name or the logo of the depository institution or an affiliate.[4] If a customer's periodic deposit account statement includes account information concerning the customer's nondeposit investment products, the information concerning these products should be clearly separate from the information concerning the deposit account and should be introduced with the minimum disclosures and the identity of the entity conducting the nondeposit transaction.

2010.6.1.3.1.3 Advertisements and Other Promotional Material

Advertisements and other promotional and sales material, written or otherwise, about nondeposit investment products sold to retail customers should conspicuously include at least the minimum disclosures discussed above and must not suggest or convey any inaccurate or misleading impression about the nature of the product or its lack of FDIC insurance. The minimum disclosures should also be emphasized in telemarketing contacts. A shorter version of the minimum disclosures is permitted in advertisements. The text of an acceptable logo-format disclosure would include the following statements:

- not FDIC-insured
- no bank guarantee
- may lose value

The logo format should be boxed, set in boldface type, and displayed in a conspicuous manner. Radio broadcasts of 30 seconds or less, electronic signs, and signs, such as banners and posters, when used only as location indicators, need not contain the minimum disclosures. Any third-party advertising or promotional material should clearly identify the company selling the nondeposit investment product and should not suggest that the depository institution is the seller. If brochures, signs, or other written material contain information about both FDIC-insured deposits and nondeposit investment products, these materials should clearly segregate information about nondeposit investment products from the information about deposits.

2010.6.1.3.1.4 Additional Disclosures

Where applicable, the depository institution should disclose the existence of an advisory or other material relationship between the institution or an affiliate of the institution and an investment company whose shares are sold by the institution and any material relationship between the institution and an affiliate involved in providing nondeposit investment products. In addition, where applicable, the existence of any fees, penalties, or surrender charges should be disclosed. These additional disclosures should be made prior to or at the time an investment account is opened to purchase these products. If sales activities include any written or oral representations concerning insurance coverage provided by any entity other than the FDIC, e.g., the Securities Investor Protection Corporation (SIPC), a state insurance fund, or a private insurance company, then clear and accurate written or oral explanations of the coverage must also be provided to customers when the representations concerning insurance coverage are made, in order to minimize possible confusion with FDIC insurance. Such representations should not suggest or imply that any alternative insurance coverage is the same as or similar to FDIC insurance.

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of the depository institution. Recommending or selling a nondeposit investment product with a name similar to that of the depository institution should only occur pursuant to a sales program designed to minimize the risk of customer confusion. The institution should take appropriate steps to ensure that the issuer of the product has complied with any applicable requirements established by the Securities and Exchange Commission regarding the use of similar names.

4. These disclosures should be made in addition to any other confirmation disclosures that are required by law or regulation, e.g., 12 C.F.R. 12 and 344, and 12 C.F.R. 208.8(k)(3).

2010.6.1.3.2 Setting and Circumstances

Selling or recommending nondeposit investment products on the premises of a depository institution may give the impression that the products are FDIC-insured or are obligations of the depository institution. To minimize customer confusion with deposit products, sales or recommendations of nondeposit investment products on the premises of a depository institution should be conducted in a physical location distinct from the area where retail deposits are taken. Signs or other means should be used to distinguish the investment sales area from the retail deposit-taking area of the institution. However, in the limited situation where physical considerations prevent sales of nondeposit products from being conducted in a distinct area, the institution has a heightened responsibility to ensure appropriate measures are in place to minimize customer confusion.

In no case, however, should tellers and other employees, while located in the routine deposit-taking area, such as the teller window, make general or specific investment recommendations regarding nondeposit investment products, qualify a customer as eligible to purchase such products, or accept orders for such products, even if unsolicited. Tellers and other employees who are not authorized to sell nondeposit investment products may refer customers to individuals who are specifically designated and trained to assist customers interested in the purchase of such products.

2010.6.1.3.3 Qualifications and Training

The depository institution should ensure that its personnel who are authorized to sell nondeposit investment products or to provide investment advice with respect to such products are adequately trained with regard to the specific products being sold or recommended. Training should not be limited to sales methods, but should impart a thorough knowledge of the products involved, of applicable legal restrictions, and of customer-protection requirements. If depository institution personnel sell or recommend securities, the training should be the substantive equivalent of that required for personnel qualified to sell securities as registered representatives.[5] Depository institution personnel with supervisory responsibilities should receive training appropriate to that position. Training should also be provided to employees of the depository institution who have direct contact with customers to ensure a basic understanding of the institution's sales activities and the policy of limiting the involvement of employees who are not authorized to sell investment products to customer referrals. Training should be updated periodically and should occur on an ongoing basis.

Depository institutions should investigate the backgrounds of employees hired for their nondeposit investment products sales programs, including checking for possible disciplinary actions by securities and other regulators if the employees have previous investment industry experience.

2010.6.1.3.4 Suitability and Sales Practices

Depository institution personnel involved in selling nondeposit investment products must adhere to fair and reasonable sales practices and be subject to effective management and compliance reviews with regard to such practices. In this regard, if depository institution personnel *recommend* nondeposit investment products to customers, they should have reasonable grounds for believing that the specific product recommended is suitable for the particular customer on the basis of information disclosed by the customer. Personnel should make reasonable efforts to obtain information directly from the customer regarding, at a minimum, the customer's financial and tax status, investment objectives, and other information that may be useful or reasonable in making investment recommendations to that customer. This information should be documented and updated periodically.

2010.6.1.3.5 Compensation

Depository institution employees, including tellers, may receive a one-time nominal fee of a fixed dollar amount for each customer referral for nondeposit investment products. The payment of this referral fee should not depend on whether the referral results in a transaction.

5. Savings associations are not exempt from the definitions of "broker" and "dealer" in sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934; therefore, all securities sales personnel in savings associations must be registered representatives.

Personnel who are authorized to sell nondeposit investment products may receive incentive compensation, such as commissions, for transactions entered into by customers. However, incentive compensation programs must not be structured in such a way as to result in unsuitable recommendations or sales being made to customers.

Depository institution compliance and audit personnel should not receive incentive compensation directly related to results of the nondeposit investment sales program.

2010.6.1.3.6 Compliance

Depository institutions should develop and implement policies and procedures to ensure that nondeposit investment product sales activities are conducted in compliance with applicable laws and regulations, the institution's internal policies and procedures, and in a manner consistent with this statement. Compliance procedures should identify any potential conflicts of interest and how such conflicts should be addressed. The compliance procedures should also provide for a system to monitor customer complaints and their resolution. Where applicable, compliance procedures also should call for verification that third-party sales are being conducted in a manner consistent with the governing agreement with the depository institution.

The compliance function should be conducted independently of nondeposit investment product sales and management activities. Compliance personnel should determine the scope and frequency of their own review, and findings of compliance reviews should be periodically reported directly to the institution's board of directors, or to a designated committee of the board. Appropriate procedures for the nondeposit investment product program should also be incorporated into the institution's audit program.

2010.6.1.4 Supervision by Banking Agencies

The federal banking agencies will continue to review a depository institution's policies and procedures governing recommendations and sales of nondeposit investment products, as well as management's implementation and compliance with such policies and all other applicable requirements. The banking agencies will monitor compliance with the institution's policies and procedures by third parties that participate in the sale of these products. The failure of a depository institution to establish and observe appropriate policies and procedures consistent with this statement in connection with sales activities involving nondeposit investment products will be subject to criticism and appropriate corrective action.

2010.6.2 SUPPLEMENTARY FEDERAL RESERVE SUPERVISORY AND EXAMINATION GUIDANCE PERTAINING TO THE SALE OF UNINSURED NONDEPOSIT INVESTMENT PRODUCTS

The above guidelines contained in the Interagency Statement on Retail Sales of Nondeposit Investment Products apply to retail recommendations or sales of nondeposit investment products made by—

- employees of a banking organization,
- employees of an affiliated or unaffiliated third party occurring on the premises of the banking organization (including telephone sales, investment recommendations by employees, and sales or recommendations initiated by mail from its premises), and
- a referral of retail customers by the institution to a third party when the depository institution receives a benefit for the referral.

The following examination procedures are intended to determine if the bank's policies and procedures provide for an operating environment that is designed to ensure customer protections in all facets of the sales program. Furthermore, examiners are expected to assess the bank's ability to conduct such sales activities in a safe and sound manner.

These procedures apply when reviewing the nondeposit investment product retail sales activities conducted by state member banks or the state-licensed U.S. branches or agencies of foreign banks. They also apply to such activities conducted by a bank holding company nonbank subsidiary on the premises of a bank.[6]

6. The interagency statement and the majority of these examination procedures apply to all depository institutions. Many of the procedures, however, may not apply directly to the inspection of bank holding companies. Some procedures may be applicable to bank holding companies from the perspective of inspecting a bank holding company with regard to its responsibility to supervise its depository institution and

The Rules of Fair Practice of the National Association of Securities Dealers (NASD) govern sales of securities by its member broker-dealers. In addition, the federal securities laws prohibit materially misleading or inaccurate representations in connection with the offer or sale of securities[7] and require that sales of registered securities be accompanied by a prospectus that complies with Securities and Exchange Commission (SEC) disclosure requirements.

In view of the existence of these securities rules and laws that are applicable to broker-dealers subject to supervision by the SEC and the NASD, examiners should note that the examination procedures contained herein have been tailored to avoid duplication of examination efforts by relying on the most recent examination results or sales-practice review conducted by the NASD and provided to the third party. To the extent that no such NASD examinations or reviews have been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination/inspection scope before proceeding further.

Notwithstanding Reserve System use of NASD results of sales-practice reviews, examiners should still complete the balance of these examination procedures, particularly those pertaining to the separation of sales of nondeposit investment products from the deposit-taking activities of the bank. Examiners should determine whether the institution has adequate policies and procedures to govern the conduct of the sales activities on a bank's premises and, in particular, whether sales of nondeposit investment products are distinguished from the deposit-taking activities of the bank through disclosure and physical means that are designed to prevent customer confusion.

Although the interagency statement does not apply to sales of nondeposit investment products to nonretail customers, such as fiduciary customers, examiners should apply these examination procedures when retail customers are directed to the bank's trust department where they may purchase nondeposit investment products simply by completing a customer agreement.

For additional information on the subject of retail sales of nondeposit investment products, examiners and other interested parties may find it helpful to refer to "Retail Investment Sales—Guidelines for Banks," February 1994 (industry guidelines), published collectively by six bank trade associations and available from the American Bankers Association, 1120 Connecticut Avenue, N.W., Washington, D.C. 20036.

holding company nonbank subsidiaries. Depository institution examination procedures and bank holding company inspection procedures have been included in this section to keep bank holding company examiners fully informed.

7. See, for example, section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)) and rule 10b-5 (17 C.F.R. 240.10b-5) thereunder.

2010.6.2.1 Program Management

Banking organizations must adopt policies and procedures governing nondeposit investment product retail sales programs. Such policies and procedures should be in place before the commencement of the retail sale of nondeposit investment products on bank premises.

The board of directors of a banking organization is responsible for ensuring that retail sales of nondeposit investment products comply with the interagency statement (see section 2010.6.1) and all applicable state and federal laws and regulations. Therefore, the board or a designated committee of the board should adopt written policies that address the risks and management of such sales programs. Policies and procedures should reflect the size, complexity, and volume of the institution's activities or, when applicable, address the institution's arrangements with any third parties selling such products on bank premises. The banking organization's policies and procedures should be reviewed periodically by the board of directors or its designated committee to ensure that the policies are consistent with the institution's current practices, applicable laws, regulations, and guidelines.

As discussed in more detail below, an institution's policies and procedures for nondeposit investment products should, at a minimum, address disclosure and advertising, physical separation of investment sales from deposit-taking activities, compliance and audit, suitability, and other sales practices and related risks associated with such activities. In addition, policies and procedures should address the following areas.

2010.6.2.1.1 Types of Products Sold

When evaluating nondeposit investment products, management should consider what products best meet the needs of customers. Policies should outline the criteria and procedures that will be used to select and periodically review

nondeposit investment products that are recommended or sold on a depository institution's premises. Institutions should periodically review products offered to ensure they meet their customers' needs.

2010.6.2.1.2 Use of Identical or Similar Names

Because of the possibility of customer confusion, a nondeposit investment product must not have a name that is identical to the name of a bank or its affiliates. However, a bank may sell a nondeposit investment product with a name similar to the bank's as long as the sales program addresses the even greater risk that customers may regard the product as an insured deposit or other obligation of the bank. Moreover, the bank should review the issuer's disclosure documents for compliance with SEC requirements, which call for a thorough explanation of the relationship between the bank and the mutual fund.

The Federal Reserve applies a stricter rule under Regulation Y (12 C.F.R. 225.125) when a bank holding company (as opposed to a bank) or nonbank subsidiary acts as an investment adviser to a mutual fund. In such a case, the fund may not have a name that is identical to, similar to, or a variation of the name of the bank holding company or a subsidiary bank.

2010.6.2.1.3 Permissible Use of Customer Information

Banking organizations should adopt policies and procedures regarding the use of confidential customer information for any purpose in connection with the sale of nondeposit investment products. The industry guidelines permit banks to share with third parties only limited customer information, such as name, address, telephone number, and types of products owned. It does not permit the sharing of more confidential information, such as specific or aggregate dollar amounts of investments, net worth, etc., without the customer's prior acknowledgment and written consent.

2010.6.2.1.4 Arrangements with Third Parties

A majority of all nondeposit investment products sold on bank premises are sold by representatives of third parties. Under such arrangements, the third party has access to the institution's customers, while the bank is able to make nondeposit investment products available to interested customers without having to commit the resources and personnel necessary to directly sell such products. Third parties include wholly owned subsidiaries of a bank, bank-affiliated broker-dealers, unaffiliated broker-dealers, insurance companies, or other companies in the business of distributing nondeposit investment products on a retail basis.

A banking institution should conduct a comprehensive review of an unaffiliated third party before entering into any arrangement. The review should include an assessment of the third party's financial status, management experience, reputation, and ability to fulfill its contractual obligations to the bank, including compliance with the interagency statement.

The interagency statement calls for banks to enter into written agreements with any affiliated and unaffiliated third parties that sell nondeposit investment products on a bank's premises. Such agreements should be approved by a bank's board of directors or its designated committee. Agreements should outline the duties and responsibilities of each party; describe third-party activities permitted on bank premises; address the sharing or use of confidential customer information for investment sales activities; and define the terms for use of the institution's office space, equipment, and personnel. If an arrangement includes dual employees, the agreement must provide for written employment contracts that specify the duties of such employees and their compensation arrangements.

In addition, a third-party agreement should specify that the third party will comply with all applicable laws and regulations and will conduct its activities in a manner consistent with the interagency statement. The agreement should authorize the bank to monitor the third party's compliance with its agreement, and authorize the institution and Federal Reserve examination staff to have access to third-party records considered necessary to evaluate such compliance. These records should include examination results, sales-practice reviews, and related correspondence provided to the third party by securities regulatory authorities. Finally, an agreement should provide for indemnification of the bank by an unaffiliated third party for the conduct of its employees in connection with sales activities.

Notwithstanding the provisions of a third-party agreement, a bank should monitor the conduct of nondeposit investment product sales

programs to ensure that sales of nondeposit investment products are distinct from other bank activities and are not conducted in a manner that could confuse customers about the lack of insurance coverage for such investments.

2010.6.2.1.5 Contingency Planning

Nondeposit investment products are subject to price fluctuations caused by changes in interest rates, stock market valuations, etc. In the event of a sudden, sharp drop in the market value of nondeposit investment products, banking institutions may experience a heavy volume of customer inquiries, complaints, and redemptions. Management should develop contingency plans to address these situations. A major element of any contingency plan should be the provision of customer access to information pertaining to their investments. Other factors to consider in contingency planning include public relations and the ability of operations staff to handle increased volumes of transactions.

2010.6.2.2 Disclosures and Advertising

2010.6.2.2.1 Content, Form, and Timing of Disclosure

Nondeposit investment product sales programs should be conducted in a manner that ensures that customers are clearly and fully informed of the nature and risks associated with these products. In addition, nondeposit investment products must be clearly differentiated from insured deposits. The interagency statement identifies the following minimum disclosures that must be made to customers when providing investment advice, making investment recommendations, or effecting nondeposit investment product transactions:

- They are not insured by the Federal Deposit Insurance Corporation (FDIC).
- They are not deposits or other obligations of the depository institution and are not guaranteed by the depository institution.
- They are subject to investment risks, including the possible loss of the principal invested.

Disclosure is the most important way of ensuring that retail customers understand the differences between nondeposit investment products and insured deposits. It is critical that the minimum disclosures be presented clearly and concisely in both oral and written communications. In this regard, the minimum disclosures should be provided—

- orally during any sales presentations (including telemarketing contacts) or when investment advice is given,
- orally and in writing before or at the time an investment account to purchase these products is opened, and
- in all advertisements and other promotional materials (as discussed further below).

The minimum disclosures may be made on a customer-account agreement or on a separate disclosure form. The disclosures must be conspicuous (highlighted through bolding, boxes, or a larger typeface). Disclosures contained directly on a customer-account agreement should be located on the front of the agreement or adjacent to the customer signature block.

Banking organizations are to obtain a written acknowledgment—on the customer-account agreement or on a separate form—from a customer confirming that the customer has received and understands the minimum disclosures. For nondeposit investment product accounts established before the interagency statement, banking organizations should obtain a disclosure acknowledgment from the customer at the time of the customer's next purchase transaction. If an institution solicits customers by telephone or mail, it should ensure that the customers receive the written disclosures and an acknowledgment to be signed and returned to the institution.

Customer-account statements (including combined statements for linked accounts) and trade confirmations that are provided by the bank or an affiliate should contain the minimum disclosures if they display the name or logo of the bank or its affiliate. Statements that provide account information about insured deposits and nondeposit investment products should clearly segregate the information about nondeposit investment products from the information about deposits to avoid customer confusion.

2010.6.2.2.2 Advertising

The interagency statement provides that advertisements in all media forms that identify specific investment products must conspicuously include the minimum disclosures and must not suggest or convey any inaccurate or misleading impressions about the nature of a

nondeposit investment product. Promotional material that contains information about both FDIC-insured products and nondeposit investment products should clearly segregate the information about the two product types. Displays of promotional sales materials related to nondeposit investment products in a bank's retail areas should be grouped separately from material related to insured bank products.

Examiners should review telemarketing scripts to determine whether bank personnel are making inquiries about customer investment objectives, offering investment advice, or identifying particular investment products or types of products. In such cases, the scripts must contain the minimum disclosures. Bank personnel relying on the scripts must be formally authorized to sell nondeposit investment products by their employers and must have training that is the substantive equivalent of that required for personnel qualified to sell securities as registered representatives (see the discussion on training below).

2010.6.2.2.3 Additional Disclosures

A depository institution should apprise customers of certain material relationships. For example, sales personnel should inform a customer orally and in writing before the sale about any advisory relationship existing between the bank (or an affiliate) and a mutual fund whose shares are being sold by the depository institution. Similarly, sales personnel should disclose fees, penalties, or surrender charges associated with a nondeposit investment product orally and in writing before or at the time the customer purchases the product. The SEC requires written disclosure of this information in the investment product's prospectus.

If sales activities include any written or oral representations concerning insurance coverage by any entity other than the FDIC (for example, Securities Investor Protection Corporation (SIPC) insurance of broker-dealer accounts, a state insurance fund, or a private insurance company), then clear and accurate explanations of the coverage must also be provided to customers at that time to minimize possible confusion with FDIC insurance. Such disclosures should not suggest that other forms of insurance are the substantive equivalent to FDIC deposit insurance.

2010.6.2.3 Setting and Circumstances

2010.6.2.3.1 Physical Separation from Deposit Activities

Selling or recommending nondeposit investment products on the premises of a banking institution may give the impression that the products are FDIC-insured or are obligations of the bank. To minimize customer confusion with deposit products, nondeposit investment product sales activities should be conducted in a location that is physically distinct from the areas where retail deposits are taken. Bank employees located at teller windows may not provide investment advice, make investment recommendations about investment products, or accept orders (even unsolicited orders) for nondeposit investment products.

Examiners must evaluate the particular circumstances of each bank in order to form an opinion about whether nondeposit investment product sales activities are sufficiently separate from deposit activities. FDIC insurance signs and promotional material related to FDIC-insured deposits should be removed from the investment-product sales area and replaced with signs indicating that the area is for the sale of investment products. Signs referring to specific investments should prominently contain the minimum disclosures. In the limited situation where physical constraints prevent nondeposit investment product sales activities from being conducted in a distinct and separate area, the institution has a heightened responsibility to ensure that appropriate measures are taken to minimize customer confusion.

A bank that enters into a third-party brokerage arrangement with a broker or dealer registered under the Securities Exchange Act of 1934 (the 1934 Act) will not itself be considered to be a broker subject to registration under the 1934 Act if the bank complies with the nine requirements set forth in section 3(a)(4)(B) of the 1934 Act. These requirements include clear identification of the broker or dealer as the person providing the brokerage services; clear physical separation of deposit-taking activities from brokerage transactions; prohibition of bank employees' receiving incentive compensation based on brokerage transactions; limitation of bank employees to clerical or ministerial functions with respect to brokerage transactions; and specific disclosures and other requirements. Failure by a bank to comply with these requirements will not automatically require the bank to register but brings into question the exemption of the

bank from the registration requirements of the 1934 Act.

Business cards for designated sales personnel should clearly indicate that they sell nondeposit investment products or, if applicable, are employed by a broker-dealer.

The interagency statement was intended to generally cover sales made to retail customers in a bank's lobby. However, some banks may have an arrangement whereby retail customers purchase nondeposit investment products at a location generally confined to institutional services (such as the corporate money desk). In such cases, the banking institutions should still ensure that retail customers receive the minimum disclosures to minimize any possible customer confusion about nondeposit investment products and insured deposits.

2010.6.2.3.2 Hybrid Instruments and Accounts

In cases in which a depository institution offers accounts that link traditional bank deposits with nondeposit investment products, such as a cash management account,[8] the accounts should be opened at the investment sales area by trained personnel. In light of the hybrid characteristics of these products, the opportunity for customer confusion is amplified, so the depository institution must take special care in the account-opening process to ensure that a customer is accurately informed that—

- funds deposited into a sweep account will only be FDIC-insured until they are swept into a nondeposit investment product account and
- customer-account statements may disclose balances for both insured and nondeposit product accounts.

2010.6.2.4 Designation, Training, and Supervision of Sales Personnel and Personnel Making Referrals

2010.6.2.4.1 Hiring and Training of Sales Personnel

Banking organizations hiring sales personnel for nondeposit investment product programs should investigate the backgrounds of prospective employees. In cases in which candidates for employment have previous investment industry experience, the bank should check whether the individual has been the subject of any disciplinary actions by securities, state, or other regulators.

Unregistered bank sales personnel should receive training that is the substantive equivalent of that provided to personnel qualified to sell securities as registered representatives. Training should cover the areas of product knowledge, trading practices, regulatory requirements and restrictions, and customer-protection issues. In addition, training programs should cover the institution's policies and procedures regarding sales of nondeposit investment products and should be conducted continually to ensure that staff are kept abreast of new products and compliance issues.

Bank employees whose sales activities are limited to mutual funds or variable annuities should receive training equivalent to that ordinarily needed to pass NASD's Series 6 limited representative examination, which typically involves approximately 30 to 60 hours of preparation, including about 20 hours of classroom training. Bank employees who are authorized to sell additional investment products and securities should receive training that is appropriate to pass the NYSE's Series 7 general securities representative examination, which typically involves 160 to 250 hours of study, including at least 40 hours of classroom training.

The training of third-party or dual employees is the responsibility of the third party. When entering into an agreement with a third party, a banking organization should be satisfied that the third party is able to train third-party and dual employees about compliance with the minimum disclosures and other requirements of the interagency statement. The bank should obtain and review copies of third-party training and compliance materials in order to monitor the third party's performance regarding its training obligations.

2010.6.2.4.2 Training of Bank Personnel Who Make Referrals

Bank employees, such as tellers and platform personnel, who are not authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products but who may refer customers to authorized

8. A hybrid account may incorporate deposit and brokerage services, credit/debit card features, and automated sweep arrangements.

nondeposit investment products sales personnel, should receive training regarding the strict limitations on their activities. In general, bank personnel who are not authorized to sell nondeposit investment products are not permitted to discuss general or specific investment products, prequalify prospective customers as to financial status and investment history and objectives, open new accounts, or take orders on a solicited or unsolicited basis. Such personnel may contact customers for the purposes of—

- determining whether the customer wishes to receive investment information;
- inquiring whether the customer wishes to discuss investments with an authorized sales representative; and
- arranging appointments to meet with authorized bank sales personnel or third-party broker-dealer registered sales personnel.

The minimum disclosure guidelines do not apply to referrals made by personnel not authorized to sell nondeposit investment products if the referral does not provide investment advice, identify specific investment products, or make investment recommendations.

2010.6.2.4.3 Supervision of Personnel

Banking institution policies and procedures should designate, by title or name, the individuals responsible for supervising nondeposit investment product sales activities, as well as referral activities initiated by bank employees not authorized to sell these products. Personnel assigned responsibility for management of sales programs for these products should have supervisory experience and training equivalent to that required of a general securities principal as required by the NASD for broker-dealers. Supervisory personnel should be responsible for the institution's compliance with policies and procedures on nondeposit investment products, applicable laws and regulations, and the interagency statement. When sales of these products are conducted by a third party, supervisory personnel should be responsible for monitoring compliance with the agreement between the bank and the third party, as well as compliance with the interagency statement, particularly the guideline calling for nondeposit investment product sales to be separate and distinct from the deposit activities of the bank.

2010.6.2.5 Suitability and Sales Practices

2010.6.2.5.1 Suitability of Recommendations

Suitability refers to the matching of customer financial means and investment objectives with a suitable product. If customers are placed into unsuitable investments, the resulting loss of consumer confidence could have detrimental effects on an institution's reputation. Many first-time investors may not fully understand the risks associated with nondeposit investment products and may assume that the banking institution is responsible for the preservation of the principal of their investment.

Banking institutions that sell nondeposit investment products directly to customers should develop detailed policies and procedures addressing the suitability of investment recommendations and related record-keeping requirements. Sales personnel who recommend nondeposit investment products to customers should have reasonable grounds for believing that the products recommended are suitable for the particular customer on the basis of information provided by the customer. A reasonable effort must be made to obtain, record, and update information concerning the customer's financial profile (such as tax status, other investments, income), investment objectives, and other information necessary to make recommendations.

In determining whether sales personnel are meeting their suitability responsibilities, examiners should review the practices for conformance with the banking institution's policies and procedures. The examiner's review should include a sample of customer files to determine the extent of customer information collected, recorded, and updated (for subsequent purchases), and whether investment recommendations appear unsuitable in light of such information.

Nondeposit investment product sales programs conducted by third-party broker-dealers are subject to NASD's suitability and other sales-practice rules. To avoid duplicating NASD examination efforts, examiners should rely on NASD's most recent sales-practice review of the third party, when available. To the extent that no such NASD review has been completed within the last two years, Reserve Banks should consult with Board staff to determine an appropriate examination scope for suitability compliance before proceeding further.

2010.6.2.5.2 Sales Practices

The banking organization should have policies and procedures that address undesirable practices by sales personnel intended to generate additional commission income through the churning or switching of accounts from one product to another.

2010.6.2.5.3 Customer Complaints

The banking organization should have policies and procedures for handling customer complaints related to nondeposit investment products. The process should provide for the recording and tracking of all complaints and require periodic reviews of complaints by compliance personnel. The merits and circumstances of each complaint (including all documentation relating to the transaction) should be considered when determining the proper form of resolution. Reasonable timeframes should be established for addressing complaints.

2010.6.2.6 Compensation

Incentive compensation programs specifically related to the sale of nondeposit investment products may include sales commissions, limited fees for referring prospective customers to an authorized sales representative, and nonmonetary compensation (prizes, awards, and gifts). Compensation that is paid by unaffiliated third parties (such as mutual fund distributors) to banking organization staff must be approved in writing by bank management; be consistent with the bank's written internal code of conduct relating to the acceptance of remuneration from third parties; and be consistent with the proscriptions of the Bank Bribery Act (18 U.S.C. 215) and the banking agencies' implementing guidelines to that act (see SR-87-36, dated October 30, 1987, or 52 *Federal Register* 39,277, October 21, 1987). Compensation policies should establish appropriate limits on the extent of compensation that may be paid to banking organization staff by unaffiliated third parties.

Incentive compensation programs must not be structured in such a way as to result in unsuitable investment recommendations or sales to customers. In addition, if sales personnel sell both deposit and nondeposit products, similar financial incentives should be in place for sales of both types of products. A compensation program that offers significantly higher remuneration for selling a specific product (for example, a proprietary mutual fund) may be inappropriate if it results in unsuitable recommendations to customers. A compensation program that is intended to provide remuneration for a group of bank employees (such as a branch or department) is permissible as long as the program is based on the overall performance of the group in meeting bank objectives regarding a broad variety of bank services and products, and is not based principally on the volume of sales on nondeposit investment products.

Individual bank employees, such as tellers, may receive a one-time nominal fee of a fixed dollar amount for referring customers to authorized sales personnel to discuss nondeposit investment products. However, the payment of the fee should not depend on whether the referral results in a transaction. Nonmonetary compensation to bank employees for referrals should be similarly structured.

Auditors and compliance personnel should not participate in incentive compensation programs directly related to the results of nondeposit investment product sales programs.

2010.6.2.7 Compliance

Institutions must develop and maintain written policies and procedures that effectively monitor and assess compliance with the interagency statement and other applicable laws and regulations and ensure appropriate follow-up to correct identified deficiencies. Compliance programs should be independent of sales activities with respect to scheduling, compensation, and performance evaluations. Compliance personnel should periodically report compliance findings to the institution's board of directors or a designated committee of the board as part of the board's ongoing oversight of nondeposit investment product activities. Compliance personnel should have appropriate training and experience with nondeposit investment product sales programs, applicable laws and regulations, and the interagency statement.

Banking organizations should institute compliance programs for nondeposit investment products that are similar to those of securities broker-dealers. This includes a review of new accounts and a periodic review of transactions in existing accounts to identify any potential abusive practices such as unsuitable recommendations or churning or switching practices. Compliance personnel should also oversee the

prompt resolution of customer complaints and review complaint logs for questionable sales practices. Compliance personnel should use MIS reports on early redemptions and sales patterns for specific sales representatives and products to identify any potentially abusive practices. In addition, referral activities of bank personnel should be reviewed to ensure that they are conducted in a manner that conforms to the guidelines in the interagency statement.

When nondeposit investment products are sold by third parties on bank premises, the bank's compliance program should provide for oversight of the third party's compliance with its agreement with the bank, including conformance to the disclosure and separate facilities guidelines of the interagency statement. The results of such oversight should be reported to the board of directors or to a designated committee of the board. Management should promptly obtain the third party's commitment to correct identified problems. Proper follow-up by the bank's compliance personnel should verify the third party's corrective actions.

2010.6.2.8 Audit

Audit personnel should be responsible for assessing the effectiveness of the depository institution's compliance function and overall management of the nondeposit investment product sales program. The scope and frequency of audit's review of nondeposit investment product activities will depend on the complexity and sales volume of a sales program, and whether there are any indications of potential or actual problems. Audits should cover all of the issues discussed in the interagency statement. Internal audit staff should be familiar with nondeposit investment products and receive ongoing training. Audit personnel should report their findings to the board of directors or a designated committee of the board, and proper follow-up should be performed. Audit activities with respect to third parties should include a review of their compliance function and the effectiveness of the bank's oversight of the third party's activities.

2010.6.2.9 Joint Interpretations of the Interagency Statement

In response to a banking association's inquiry, the banking supervisory agencies issued on September 12, 1995, joint interpretations regarding the February 1994 Interagency Statement on Retail Sales of Nondeposit Investment Products by banking and thrift organizations, previously discussed. The agencies also authorized the use of alternative abbreviated minimum disclosures for advertisements. The alternative minimum disclosures need not be made at all in certain types of advertisements. The use of abbreviated disclosures offers an optional alternative to the longer disclosures prescribed by the interagency statement.

2010.6.2.9.1 Disclosure Matters

The agencies agreed that there are limited situations in which the disclosure guidelines need not apply or where a shorter logo format may be used in lieu of the longer written disclosures called for by the interagency statement.

The interagency statement disclosures do not need to be provided in the following situations:

- radio broadcasts of 30 seconds or less
- electronic signs[9]
- signs, such as banners and posters, when used only as location indicators

Additionally, third-party vendors not affiliated with the depository institution need not make the interagency statement disclosures on nondeposit investment product confirmations and in account statements that may incidentally, with a valid business purpose, contain the name of the depository institution.

The banking agencies have been asked whether shorter, logo-format disclosures may be used in visual media, such as television broadcasts, ATM screens, billboards, signs, and posters, and in written advertisements and promotional materials, such as brochures. The text of an acceptable logo-format disclosure would include the following statements:

- not FDIC-insured
- no bank guarantee
- may lose value

The logo-format disclosures would be boxed, set in boldface type, and displayed in a conspicuous manner. The full disclosures prescribed

9. "Electronic signs" may include billboard-type signs that are electronic, time and temperature signs, and ticker-tape signs. Electronic signs would not include media such as television, on-line services, or ATMs.

by the interagency statement should continue to be provided in written acknowledgment forms that are signed by customers. An example of an acceptable logo disclosure is—

NOT FDIC-INSURED	May lose value No bank guarantee

2010.6.2.9.2 Joint Interpretations on Retail Sales of Nondeposit Investment Products

The banking agencies' joint statement also addressed the following:

- *Sales from lobby area presumed retail*. Retail sales include (but are not limited to) sales to individuals by depository institution personnel or third-party personnel conducted in or adjacent to a depository institution's lobby area. Sales activities occurring in another location of a depository institution may also be retail sales activities covered by the interagency statement depending on the facts and circumstances.
- *Government or municipal securities dealers or desks*. Sales of government and municipal securities made in a depository institution's dealer department that is located away from the lobby area are not subject to the interagency statement. Such departments are already regulated by the banking agencies and are subject to the statutory requirements for registration of government and municipal securities brokers and dealers. Further, such brokers and dealers are subject to sales-practice and other regulations of the Department of the Treasury, the SEC, and designated securities self-regulatory organizations.
- *Fiduciary accounts, affiliated trust companies, and custodian accounts*. The interagency statement generally does not apply to fiduciary accounts administered by a depository institution. However, for fiduciary accounts in which the customer directs investments, such as self-directed individual retirement accounts, the disclosures prescribed by the interagency statement should be provided. Nevertheless, disclosures need not be made to customers acting as professional money managers. Fiduciary accounts administered by an affiliated trust company on the depository institution's premises would be treated the same way as the fiduciary accounts of the institution.

  With respect to custodian accounts maintained by a depository institution, the interagency statement does not apply to traditional custodial activities, for example, collecting interest and dividend payments for securities held in the accounts or handling the delivery or collection of securities or funds in connection with a transaction.
- *Affiliated stand-alone broker-dealers*. The statement applies specifically to sales of nondeposit investment products on the premises of a depository institution, for example, whenever sales occur in the lobby area. The statement also applies to sales activities of an affiliated stand-alone broker-dealer resulting from a referral of retail customers by the depository institution to the broker-dealer.

2010.6.3 INSPECTION/EXAMINATION OBJECTIVES

1. To determine that the banking organization has taken appropriate measures to ensure that retail customers clearly understand the differences between insured deposits and nondeposit investment products and receive the minimum disclosures both orally during sales presentations (including telemarketing) and in writing.
2. To assess the adequacy of the institution's policies and procedures, sales practices, and oversight by management and the board of directors to ensure an operating environment that fosters customer protection in all facets of the sales program.
3. To ensure that the sales program is conducted in a safe and sound manner that is in compliance with the interagency statement, Federal Reserve guidelines, regulations, and applicable laws.
4. To assess the effectiveness of the institution's compliance and audit programs for nondeposit investment product operations.
5. To obtain commitments for corrective action when policies, procedures, practices, or management oversight is deficient or the institution has failed to comply with the inter-

agency statement or applicable laws and regulations.

2010.6.4 INSPECTION/EXAMINATION PROCEDURES

2010.6.4.1 Scope of the Procedures

These procedures are based on the guidelines outlined in the interagency statement. The interagency statement applies to all banking organizations, including state member banks and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

These examination procedures are intended to be used when examining a state member bank (or a state-licensed U.S. branch or agency of a foreign bank) that engages directly in the retail sale of nondeposit investment products.

This set of examination procedures is also meant to be used in conjunction with other procedures in this manual when examining a nonbank subsidiary that sells nondeposit investment products on bank premises. See the following sections for related examination procedures:

- Section 3130.1: Section 4(c)(8) of the BHC Act—Investment or Financial Advisers
- Section 3230.0: Section 4(c)(8) of the BHC Act—Securities Brokerage
- Section 3600.27: Providing Administrative and Certain Other Services to Mutual Funds

Program Management and Organization

1. Evaluate the institution's structure and reporting lines (legal and functional) for its retail nondeposit investment products operations. Determine whether retail sales of nondeposit investment products are being made directly by employees of the depository institution or through an affiliated or unaffiliated third party. Identify the principals responsible for the management of the nondeposit investment products sales program. Review their backgrounds, qualifications, and tenure with the institution.
2. Determine the role of the board of directors of each legal entity involved in the sale of nondeposit investment products in authorizing and controlling nondeposit investment products activities on bank premises. Evaluate the adequacy of MIS reports relied on by the board (or a designated committee) and senior management to manage these activities.
3. Describe the membership and responsibilities of management or board committees for nondeposit investment product retail sales programs. Review the minutes maintained by these committees for information related to the conduct of retail nondeposit investment product sales programs.
4. Review and evaluate the institution's policies and procedures, objectives, and budget for nondeposit investment products activities. In so doing, consider the following:
   a. who prepared the material
   b. how it fits into the institution's overall strategic objectives
   c. whether the goals and objectives are realistic
   d. whether actual results are routinely compared to plans and budgets
5. Determine how policies and procedures for nondeposit investment products activities are developed and at what level in the institution they are formally approved. Review the policies and procedures to see that they are consistent with the interagency statement and address the following matters:
   a. disclosure and advertising
   b. physical separation from deposit-taking activities
   c. compliance programs and internal audit
   d. hiring, training, supervision, and compensation practices for sales staff and personnel making referrals
   e. types of products offered, selection criteria
   f. restrictions on a mutual fund's use of names similar or identical to that of the bank holding company or its subsidiary banks
   g. suitability and sales practices
   h. use of customer information
   i. transactions with affiliated parties
   j. role of third parties, if applicable
6. Determine how management oversees compliance with the policies and procedures in item 5.
7. Review the product selection and development process to ensure that it considers customer needs and investment objectives.
8. Determine if the depository institution is covered by blanket bond insurance applicable to nondeposit investment product retail sales activities.
9. If the institution sells proprietary nondeposit investment products and performs related back-office operations, review—

a. the work flow and position responsibilities within the sales and operations function, and
b. available flow charts, job descriptions, and policies and procedures.

After discussions with management, conduct a walk-through, tracing the path of a typical transaction. Evaluate the effectiveness and efficiency of the work flow and the overall operation.

10. Determine whether the institution has established any contingency plans for handling adverse events affecting nondeposit investment product programs, such as a sudden market downturn or period of heavy redemptions.
11. Review the institution's earnings and evaluate the—
    a. profitability of nondeposit investment products activities, including any investment advisory fees it may receive, and
    b. income and expense from the sales, investment advisory, and proprietary fund management activities related to nondeposit investment products, as a percentage of non-interest income and expense.

Disclosures and Advertising

The interagency statement identifies certain minimum disclosures that must be made to customers. The disclosures must state that nondeposit investment products—

- are not insured by the FDIC;
- are not deposits or other obligations of the institution and are not guaranteed by the institution; and
- are subject to investment risks, including the possible loss of the principal invested.

12. Determine whether the minimum disclosures are being provided orally to customers during sales presentations (including telemarketing contacts) or when giving investment advice on specific investment products.
13. Determine if the customer-account agreement (or a separate disclosure form) presents the minimum disclosures clearly and conspicuously. The disclosures should be prominent (highlighted through bolding, boxes, or a larger typeface) and should be located on the front of the customer-account agreement or adjacent to the customer signature block.
14. Determine whether customers sign an acknowledgment that they have received and understand the minimum disclosures. The acknowledgment can be on the customer-account agreement or it can be on a separate disclosure form. Determine if customers who opened accounts before the interagency statement was issued receive the written minimum disclosures and acknowledge receipt at the time of their next transaction. Review a sample of customer accounts to determine whether customers received the minimum oral and written disclosures.
15. When sales confirmations or account statements provided by the bank or an affiliate bear the name or logo of the bank or an affiliate, determine whether the minimum disclosures are conspicuously displayed on the front of the documents.
16. Review advertisements and promotional material that identify specific nondeposit investment products to determine whether they conspicuously display the minimum disclosures or the abbreviated logo-format disclosures. Any materials that contain information about insured deposits and nondeposit investment products should clearly segregate the information about investment products from the information about deposits.
17. Review telemarketing material used to solicit new business. To the extent that employees identify specific products, seek customer investment objectives, make investment recommendations, or give investment advice, determine whether—
    a. the minimum disclosures are included in the script;
    b. bank employees engaged in telemarketing activities are authorized by the bank to recommend or sell nondeposit investment products, and whether their training is the substantive equivalent of that required for securities registered representatives; and
    c. the material contains any statements that may be misleading or confusing to customers regarding the uninsured nature of nondeposit investment products.
18. When nondeposit investment products are sold by employees of an affiliated broker-dealer, determine if any written or oral representations concerning insurance coverage provided by SIPC, a state insurance fund, or

a private insurance company are clear and accurate and do not suggest that they are the substantive equivalent to FDIC insurance available for certain deposit products.

19. When the bank or its bank holding company (or affiliate) acts as an investment adviser to or has some other material relationship with a mutual fund whose shares are sold by the bank, determine whether—
    a. oral and written disclosure of the relationship is made before the purchase of the shares;
    b. bank-advised mutual funds do not have names identical to the bank's;
    c. bank-advised mutual funds with names similar to the bank's are sold pursuant to a sales program designed to minimize the risk of customer confusion; and
    d. mutual funds advised by bank holding companies do not have names identical to, similar to, or a variation of the name of the holding company or its subsidiary bank.
20. Determine whether disclosure of any sales charges, fees, penalties, or surrender charges relating to nondeposit investment products is made orally and in writing before the purchase of these products.

Third-Party Agreements

21. When sales of nondeposit investment products are conducted by employees or representatives of a third party, review all contractual agreements between the bank and the third party to determine whether they cover the following:
    a. duties and responsibilities of each party
    b. third-party compliance with all applicable laws and regulations and the interagency statement
    c. authorization for the institution to oversee and verify compliance by the third party
    d. provision for access to relevant records to the appropriate bank supervisory authorities
    e. written employment contracts for dual employees
    f. indemnification of the institution by the third party for the conduct of its employees in connection with nondeposit investment product sales activities
    g. policies regarding the use of confidential customer information for any purpose in connection with sales of nondeposit investment products.
22. Obtain and review the most recent NASD examination results for the third party from the bank or the third-party broker-dealer. Also obtain and review examination-related correspondence and any disciplinary matters between the broker-dealer and the NASD or SEC. Review the institution's progress in addressing any investment recommendations or deficiencies noted in the examination results or other material.
23. Where any retail sales facilities of the institution are leased to an affiliated third party that sells nondeposit investment products—
    a. assess whether the lease was negotiated on an arm's-length basis and on terms comparable to similar lease agreements in the local market and
    b. review any intercompany relationships for compliance with sections 23A and 23B of the Federal Reserve Act.

Settings and Circumstances

24. Determine whether the sale of nondeposit investment products is conducted in a physical location distinct from deposit-taking activities of the bank. In so doing—
    a. verify that nondeposit investment products are not sold from teller windows;
    b. determine if signs or other means are used to distinguish the nondeposit investment products sales area from the retail deposit-taking area of the institution; and
    c. determine whether space limitations preclude having a separate investment-products sales area. If so, note how the institution clearly distinguishes nondeposit investment products from insured bank products or obligations.

Qualifications and Training

25. Determine whether employees of a depository institution are providing investment advice, making investment recommendations, or selling nondeposit investment products directly to retail customers. If so, determine whether—
    a. the depository institution has performed background checks and
    b. sales personnel have received training that is the substantive equivalent to

that provided to a securities registered representative.

26. Review the training program provided to employees of the depository institution who are authorized to provide investment advice, make investment recommendations, or sell nondeposit investment products. Assess whether the program addresses the following subject matters:
    a. general overview of U.S. financial markets
    b. detailed information concerning specific product lines being offered for sale
    c. generally accepted trading practices for the products available for sale
    d. general overview of federal securities laws and regulations (antifraud and disclosure)
    e. banking regulations and guidelines applicable to sales activities (such as antitying prohibitions, the interagency statement, supervisory letters on sales of specific investment products, etc.)
    f. policies and procedures specific to the institution
    g. appropriate sales practices, including suitability of investment recommendations and disclosure obligations
    h. appropriate use of customer lists and confidential customer information
27. Determine whether the institution has any continuing-education program or periodic seminars on new products or compliance.
28. Determine whether supervisors of bank sales personnel receive special training pertaining to their supervisory responsibilities that is the substantive equivalent of training required for supervisors (General Securities Principals) of registered representatives.
29. Review the training of bank employees who are not authorized to sell nondeposit investment products but who make referrals, such as tellers, customer service representatives, and others. In so doing, determine whether such employees have been provided training in appropriate referral practices, including the limits on their activities.

Suitability and Sales Practices

The following procedures on suitability and sales practices are applicable when conducting an examination of a depository institution whose employees offer investment advice, make investment recommendations, or sell nondeposit investment products. Examinations involving registered broker-dealers should rely on the NASD's review of sales practices or its examination to assess the organization's compliance with suitability requirements.

30. Determine whether depository institution personnel recommend nondeposit investment products to customers. If so, determine whether sales personnel obtain, record, and update the following information:
    a. age
    b. tax status
    c. current investments and overall financial profile, including an estimate of net worth*
    d. investment objectives*
    e. other personal information deemed necessary to offer reasonable investment advice*
31. Review a representative sample of customer accounts that were opened at several different branch locations. Assess whether customer suitability information is obtained and whether investments appear unsuitable in light of such information.
32. Review customer complaints involving suitability of investment recommendations. Determine whether the bank's original recommendations appear unsuitable in the context of the information available at the time of sale. Note how suitability complaints are resolved.

Compensation

33. If employees of the depository institution provide investment advice, make investment recommendations, or sell nondeposit investment products, determine whether—
    a. any incentive compensation plan available to nondeposit investment product sales personnel strongly favors proprietary or other specific products; if so, determine how the institution ensures that customers are not placed into unsuitable investments, and
    b. compliance and audit personnel are excluded from incentive compensation programs directly related to the results of nondeposit investment product sales.

* Not necessary when money market mutual funds are being recommended.

34. Determine whether fees paid to bank employees for referrals to depository institution sales personnel or third-party sales staff are based on a one-time, nominal fee of a fixed dollar amount and are not dependent on a successful sale.
35. Determine if the bank's compensation policies address remuneration of bank employees by third parties and if these policies are incorporated into the bank's code of conduct. In so doing, determine whether the bank's policies were approved by the board of directors and are consistent with the proscriptions of the Bank Bribery Act and the interagency guidelines adopted thereunder.

Compliance and Audit

36. Review and assess the depository institution's compliance program for nondeposit investment product sales activities. In so doing, consider the following:
    a. frequency and scope
    b. workpapers
    c. degree of independence from the sales program
    d. follow-up on material findings
    e. centralization of findings from all compliance areas
    f. role of the board of directors in reviewing findings
37. Review the criteria used to evaluate bank sales personnel for compliance with the institution's policies and procedures, specifically those policies relating to disclosure and suitability.
38. Determine whether compliance personnel approve or review new accounts, periodically review transactions in accounts, and review sales and referral activities of bank personnel.
39. Review the customer complaint process and the associated complaint log to determine if complaints are addressed on a timely basis.
40. Review progress in addressing identified compliance problems.
41. Evaluate the experience, training, and qualifications of compliance personnel.
42. Review the scope of audits and determine if the following areas were adequately addressed:
    a. disclosure and advertising
    b. physical separation of nondeposit investment product sales activities
    c. compliance
    d. sales practices and suitability
    e. product selection and development
    f. use of confidential customer information by bank and third-party sales personnel
    g. third-party compliance with its agreement with the institution
    h. personnel training and background checks
    i. operations (clearing, cash receipts and disbursements, accounting, redemptions, etc.), if applicable
43. Obtain all internal and external audit reports regarding the institution's nondeposit investment product activities performed over the past year (including management's responses). Review for exceptions, recommendations, and follow-up actions. Ascertain if significant exceptions were presented to the institution's audit committee or board of directors for their review.
44. For external audits, obtain a copy of the engagement letter and comment on the adequacy of the firm's audit review.

Supervision of Subsidiaries (Sharing of Facilities and Staff by Banking Organizations) Section 2010.8

A banking organization should be able to readily determine for which entity within the bank holding company an individual is employed, and members of a banking organization's staff must be able to identify which subsidiary of the holding company employs them. The distinction is important because complex banking organizations must take steps to ensure that their officials and employees have both the corporate and legal authority to carry out their duties, and because the organization's personnel should only be performing activities that are permitted by law to be carried out by the holding company or its particular subsidiaries.

2010.8.1 IDENTIFICATION OF FACILITIES AND STAFF

Generally, unless there are statutory restrictions or the Federal Reserve or other regulators have issued explicit written proscriptions, such as those concerning mutual fund sales on bank premises, there is no fundamental legal prohibition on the entities of a banking organization sharing or using unmarked contiguous facilities and, in some instances, sharing officials and employees. There are, however, concerns about safety and soundness and conflicts of interest. These may arise when a banking organization does not take appropriate actions to define and differentiate the functions and responsibilities of each of its entities and staff.

Good corporate governance requires that a banking organization be able to readily identify the authority and responsibilities of its officials and employees at each of its entities, especially where the entities share facilities or use contiguous offices that are not clearly marked to indicate the identity of the different entities. This is necessary to ensure that—

1. an official or employee who makes a commitment to a counterparty on behalf of the organization has both the corporate and legal authority to do so,
2. the counterparty understands with whom it is dealing, and
3. each entity is in compliance with any legal restrictions under which it operates.

To accomplish the goal of ready identification, a banking organization should maintain well-defined job descriptions for each category of its staff at each entity. When officials and employees of one entity have responsibilities for other entities, particularly in shared facilities, the staff's responsibilities should be clearly defined and, when appropriate, disclosed or made clear to customers and the public in general. This procedure clarifies for both the public and the regulators for which entity officials or employees are carrying out their duties and responsibilities. Also, this clarifies whether an entity is operating within the scope of its charter, license, or other legal restrictions. Finally, a banking organization should establish and maintain appropriate internal controls designed to ensure the separation of the functions of the legal entities, when required, as well as have an adequate audit program to monitor such activities.

If officials and employees have responsibilities for other offices or affiliates of the banking organization, particularly those that share facilities, these responsibilities should be clearly defined and, when appropriate, disclosed or made clear to customers and the public in general. This procedure clarifies for which entity employees are carrying out their duties. Furthermore, in establishing employee responsibilities, management should ensure that they are within the scope of the entity's license or charter.

2010.8.2 EXAMINER GUIDANCE ON SHARING FACILITIES AND STAFF

Examiners should continue to be fully aware of the issues and potential problems involved in the sharing of staff and the sharing or use of unmarked contiguous facilities by the different entities of a banking organization with varied activities. At a minimum, examiners should check to see that a banking organization maintains clear records indicating the duties and responsibilities of the officials and employees at each of its entities. They should also take steps to check whether, in situations when an official or employee may perform duties for more than one entity in a shared facility, the banking organization has adequate policies and controls in place to ensure that its staff have the corporate and legal capacity to commit the organization to its counterparties and that the duties are carried out in conformance with the statutory restrictions applicable to each of the entities. See SR-95-34 (SUP).

One of the many basic tenets of internal control is that a banking organization (bank holding company, state member bank, and foreign banking organization) needs to ensure that its employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks. Such a requirement enhances the viability of a sound internal control environment because most frauds or embezzlements require the continuous presence of the wrongdoer.

In brief, this section contains a statement emphasizing the need for banking organizations to conduct an assessment of significant risk areas before developing a policy on required absences from sensitive positions. After making this assessment, the organization should require that employees in sensitive key positions, such as trading and wire transfer, not be allowed to transact or otherwise carry out, either physically or through electronic access, their assigned duties for a minimum of two consecutive weeks per year. The prescribed period of absence should, under all circumstances, be sufficient to allow all pending transactions to clear. It should also require that an individual's daily work be processed by another employee during the employee's absence.

2010.9.1 STATEMENT ON REQUIRED ABSENCES FROM SENSITIVE POSITIONS

A comprehensive system of internal controls is essential for a financial institution to safeguard its assets and capital, and to avoid undue reputational and legal risk. Senior management is responsible for establishing an appropriate system of internal controls and monitoring compliance with that system. Although no single control element should be relied on to prevent fraud and abuse, these acts are more easily perpetrated when proper segregation and rotation of duties do not exist. As a result, the Federal Reserve is reemphasizing the following prudent banking practices that should be incorporated into a banking organization's internal control procedures. These practices are designed to enhance the viability of a sound internal control environment, as most internal frauds or embezzlements necessitate the constant presence of the offender to prevent the detection of illegal activities.

When developing comprehensive internal control procedures, each banking organization should first make a critical assessment of its significant areas and sensitive positions. This assessment should consider all employees, but should focus more on those with authority to execute transactions, signing authority and access to the books and records of the banking organization, as well as those employees who can influence or cause such activities to occur. Particular attention should be paid to areas engaged in trading and wire-transfer operations, including personnel who may have reconciliation or other back-office responsibilities.

After producing a profile of high-risk areas and activities, it would be expected that a minimum absence of two consecutive weeks per year be required of employees in sensitive positions. The prescribed period of absence should, under all circumstances, be sufficient to allow all pending transactions to clear and to provide for an independent monitoring of the transactions that the absent employee is responsible for initiating or processing. This practice could be implemented through a requirement that affected employees take vacation or leave, the rotation of assignments in lieu of required vacation, or a combination of both so the prescribed level of absence is attained. Some banking organizations, particularly smaller ones, might consider compensating controls such as continuous rotation of assignments in lieu of required absences to avoid placing an undue burden on the banking organization or its employees.

For the policy to be effective, individuals having electronic access to systems and records from remote locations must be denied this access during their absence. Similarly, indirect access can be controlled by not allowing others to take and carry out instructions from the absent employee. Of primary importance is the requirement that an individual's daily work be processed by another employee during his or her absence; this process is essential to bring to the forefront any unusual activity of the absent employee.

Exceptions to the required-absence policy may be necessary from time to time. However, management should exercise the appropriate discretion and properly document any waivers that are granted. Internal auditing should be made aware of individuals who receive waivers and the circumstances necessitating the exceptions.

If a banking organization's internal control procedures do not now include the above practices, they should be promptly amended. After

the procedures have been enhanced, they should be disseminated to all employees, and the documentation regarding their receipt and acknowledgment maintained. Additionally, adherence to the procedures should be included in the appropriate audit schedules, and the auditors should be cognizant of potential electronic access or other circumventing opportunities.

The development and implementation of procedures on required absences from sensitive positions is just one element of an adequate control environment. Each banking organization should take all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.

2010.9.2 INSPECTION OBJECTIVES

1. To determine whether a critical assessment has been performed of a banking organization's significant areas and sensitive positions.
2. To ascertain that sound internal controls exist, including policies and procedures that provide assurances that employees in sensitive positions are absent from their duties for a minimum of two consecutive weeks per year.
3. To ascertain whether the banking organization has taken all measures to establish appropriate policies, limits, and verification procedures for an effective overall risk-management system.
4. To establish that the appropriate audit schedules and the audits include a review of minimum absence policies and procedures, including potential electronic access or other circumventing actions by employees.

2010.9.3 INSPECTION PROCEDURES

1. Determine that a profile of high-risk areas and activities is performed on a regular periodic basis.
2. Ascertain if employees assigned to sensitive positions are required to be absent for a minimum of two weeks per year while—
   a. pending sensitive transactions are monitored while they clear, and
   b. daily work is monitored and processed by another employee during the regularly assigned employee's absence.
3. Determine if required internal control procedures for minimum absences (for example, rotation of assignments, vacation or leave, or a combination of both) are being used in sensitive operations such as trading, trust, wire transfer, reconciliation, or other sensitive back-office responsibilities.
4. Ascertain if appropriate policies, limits, and verification procedures have been established and maintained for an effective overall risk-managment system.
5. Determine whether the banking organization—
   a. prohibits others from taking and carrying out instructions from the absent employees, and
   b. prevents remote electronic access to systems and records involving sensitive transactions during the regularly assigned employee's required minimum two-week absence.
6. Ascertain that the banking organization documents waivers from the two-week minimum absence policies and procedures involving sensitive positions.
7. Determine that the appropriate audit schedules and the audits include a review of such procedures, including potential electronic access or other circumventing actions by employees.

Internal loan review is an activity which provides management with information about the quality of loans and effectiveness of a banking organization's lending policies and procedures. The objectives of loan-review procedures are to identify, in a timely manner, existing or emerging credit-quality problems and to determine whether internal lending policies are being adhered to.

The size and complexity of a bank holding company will dictate the need for and structure of internal loan review. One-bank holding companies with no significant credit-extending nonbank subsidiaries will normally establish internal loan-review procedures within the subsidiary bank. In these cases, there is no need to evaluate the loan-review procedures during the inspection.

For larger multibank companies or those with significant credit-extending nonbank subsidiaries, internal loan review is usually centralized at the parent company level. In some cases, a centralized loan-review function could operate in the lead bank and cover all affiliates within the organization. However, since parent company directors and senior management are ultimately accountable for the organization's asset quality, an evaluation of the internal loan-review function should be conducted as part of the inspection process no matter where the operations are technically located within the corporate structure. Since a subsidiary bank's primary regulator will normally want to evaluate the loan-review process as it relates to the respective bank, a coordination of efforts would be appropriate. This should be handled on an ad hoc basis, as deemed necessary by the holding company's examiner-in-charge, to avoid unnecessary duplication of efforts without compromising the independence of the appraisal process.

Internal loan-review procedures may take various forms, from senior officers' review of junior-officer loans to the formation of an independent department staffed by loan-review analysts. An effective system will identify deteriorations in credits, loans that do not comply with written loan policies, and loans with technical exceptions.

The loan-review program should be delegated to a qualified and adequate staff. The review should be systematic in scope and frequency. All related extensions of credit should be identified and analyzed together. A minimum credit size should be established that allows for an efficient review while providing adequate coverage. The process should also tie problem loans or technical exceptions to the particular loan officer to allow senior management to evaluate individual performance. Loans should be reviewed shortly after origination to determine their initial quality, technical exceptions, and compliance with written loan policies. Reasonable frequency guidelines should be set for normal reviews, with problem credits receiving special and more frequent analysis. An effective loan-review procedure will incorporate an early warning system of "red flags," such as overdrafts, adverse published reports, and deteriorating financial statements. Loan officers should also be encouraged to inform the organization's internal loan-review unit of developing loan problems, and they should be discouraged from withholding problem loans or adverse information from the review process.

The loan-review process should be independent of the loan-approval function, with written findings reported to a board or senior management committee that is not directly involved in lending. Follow-up and monitoring of problem credits should be instituted. The loan officer should be responsible for reporting on any corrective actions taken. The maintenance of adequate internal controls within the lending process, in particular for loan review or credit audit, is critical for maintaining proper incentives for banking organization staff to be rigorous and disciplined in their credit-analysis and lending decisions. A banking organization's credit analyses, loan terms and structures, credit decisions, and internal rating assignments have historically been reviewed in detail by experienced and independent loan-review staff. Such loan reviews have provided both motivation for better credit discipline within an institution and greater comfort for examiners—and management—that internal policies are being followed and that the banking organization continues to adhere to sound lending practice.

For larger multibank organizations, loan-review procedures are usually centralized and administered at the parent level, with loan-review staff employed by the parent company. In some cases, a centralized loan-review function may operate in the lead bank, covering all other affiliates in the organization. The parent company directors and senior management are ultimately accountable for supervision of the entire organization's asset quality. Therefore, it

should be the System's responsibility to evaluate top management's loan-review policies and procedures as they relate to the subsidiaries, both bank and nonbank, no matter where the function is technically established within the corporate structure. The holding company examiner-in-charge should attempt to coordinate efforts and cooperate with the respective banks' primary supervisors to avoid unnecessary duplication, without compromising the independence of the appraisal process.

During favorable economic and financial markets, relatively low levels of problem loans and credit losses may increase pressure within banking organizations to reduce the resources committed to loan-review functions. These reductions may include a reduction in staff, more limited portfolio coverage, and less thorough reviews of individual loans. Undoubtedly, some useful efficiencies may be gained by reducing loan-review resources, but some banking organizations may reduce the scope and depth of loan-review activities beyond levels that are prudent over the longer horizon. If reduced too far, the integrity of the lending process and the discipline of identifying unrealistic assumptions and discerning problem loans in a timely fashion may deteriorate. This may be especially true when a large proportion of lenders may not have had direct lending experience during a credit cycle when there was an economic and financial market downturn. See SR-99-23.

If supervisors and examiners find that there are weaknesses in the internal loan-review function and in activities or other internal control and risk-management processes (for example, staff turnover, failure to commit sufficient resources, inadequate adherence to established internal controls, or inadequate training), such findings should be discussed with the senior management of the parent bank holding company or other management at a corporate-wide level and, if determined to be a major concern, presented as comments on the "Examiner's Comments and Matters Requiring Special Board Attention" core page. Findings that could adversely affect affiliated insured depository institutions should be conveyed to the primary federal or state supervisor of the insured institution. Those findings should also be considered when assigning supervisory ratings.

Shell one-bank holding companies will not have or need a loan-review program emanating from the parent company level. Loan review will normally function within the subsidiary bank and be supervised by bank directors and management.

2010.10.1 INSPECTION OBJECTIVES

1. Review the operations of the bank holding company to determine whether there is an internal loan-review program. If not, one should be implemented.
2. Determine whether the loan-review program is independent from the loan-approval function.
3. Determine if the loan-review staff is sufficiently qualified and whether its size is adequate.
4. Determine whether the scope and frequency of the loan-review procedure is adequate to ensure that problems are being identified.
5. Determine that findings from the loan-review process are being properly reported and receive adequate follow-up attention.

2010.10.2 INSPECTION PROCEDURES

1. Review the holding company's operations to determine what types of internal loan-review procedures are being performed and whether an internal loan-review program exists.
2. If no internal loan-review program exists, determine whether the size, complexity, and financial condition of the organization warrants implementation of a formal loan-review process.
3. Review the organizational structure of the loan-review function to ensure its independence from the loan-approval processes.
4. Review the reporting process for internal loan-review findings to determine whether a director committee or independent senior management committee is being appropriately advised of the findings. Determine whether adequate follow-up procedures are in place.
5. Through loan reviews, transaction testing, and discussions with loan-review management, evaluate the quality, effectiveness and adequacy of the internal loan-review staff and internal controls in relation to the organization's size and complexity.
6. Review the operation of the loan-review process to identify the method for selecting loans and the manner in which they are analyzed and graded. Determine whether these procedures are adequate.

7. Determine if loan-review activities or other internal control and risk-management processes have been weakened by turnover of internal loan-review staff; a failure to commit sufficient resources; inadequate internal controls; inadequate training; or the absence of other adequate systems, resources, or controls. If such significant findings are found, discuss those concerns with senior management and report those findings on the core page 1, "Examiner's Comments and Matters Requiring Special Board Attention."
8. Determine what type of "early warning" system is in place and whether it is adequate.
9. Determine how the scope and frequency of the review procedure is established and whether this provides adequate coverage.

WHAT'S NEW IN THIS REVISED SECTION

Effective January 2006, this section has been revised to incorporate the statutory requirements of the USA Patriot Act. The requirements of the USA Patriot Act are designed to prevent, detect, and prosecute money laundering and terrorist financing. For banking organizations, the act's provisions are implemented through regulations issued by the U.S. Department of the Treasury (31 C.F.R. 103). Section 326 of the Patriot Act (codified in the Bank Secrecy Act (BSA) at 31 U.S.C. 5318(l)) requires financial institutions to have customer identification programs, that is, programs to collect and maintain certain records and documentation on customers. Institutions are to develop and use identity verification procedures to ensure the identity of their customers. Bank holding companies, as a matter of safety and soundness, should take appropriate measures to ensure that their financial institution subsidiaries are in compliance with the customer identification program (CIP) rule.

The CIP rule for banks (see 31 C.F.R. 103.121) applies only to a bank, not to a bank holding company solely because it owns a bank. Also, a nonbank subsidiary of a bank holding company is not subject to the CIP rule for banks solely as a result of being affiliated with a bank in a holding company structure. Even though this rule is not applicable to bank holding companies and their nonbank subsidiaries (or to savings and loan holding companies and their non–savings association subsidiaries), bank holding companies should, as a matter of safety and soundness, take appropriate measures throughout the organization to ensure that each of their entities is in compliance with any applicable CIP rule. New accounts must receive appropriate due diligence, and a holding company should generally protect the consolidated organization from any risks associated with money laundering and financial crime. The bank holding company may still be subject to other CIP rules if it has ownership in a functionally regulated entity, for example, a securities broker-dealer. (See 31 C.F.R. 103.22)

2010.11.1 OVERVIEW OF PRIVATE BANKING AND ITS ASSOCIATED ACTIVITIES

The role of bank regulators in supervising private-banking activities is (1) to evaluate management's ability to measure and control the risks associated with such activities and (2) to determine if the proper internal control and audit infrastructures are in place to support effective compliance with relevant laws and regulations. In this regard, the supervisors may determine that certain risks have not been identified or adequately managed by the institution, a potentially unsafe and unsound banking practice.

Private-banking functions may be performed in a specific department of a commercial bank or nonbank subsidiary of a commercial bank, a bank holding company (including a financial holding company), an Edge corporation or its foreign subsidiaries, a branch or agency of a foreign banking organization, or within multiple areas of an institution. Private banking may be the sole business of an institution. Regardless of how an institution is organized or where it is located, the results of the private-banking review should be reflected in the entity's overall supervisory assessment.[1]

This section provides examiners with guidance for reviewing private-banking activities at all types and sizes of banking organizations, including financial institutions. It is intended to supplement, not replace, existing guidance on the inspection or examination of private-banking activities and to broaden the examiner's review of general risk-management policies and practices governing private-banking activities. In addition to providing an overview of private banking, the general types of customers, and the various products and services typically provided, the "Functional Review" subsection describes the critical functions that constitute a private-banking operation and identifies certain safe and sound banking practices. These critical functions are supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance. Included in the risk-

1. Throughout this section, the word institution will be used to mean all types of banking organizations, including bank holding companies, their bank and other financial institution subsidiaries, nonbank subsidiaries, and those entities authorized to operate under section 4(k) of the Bank Holding Company Act. Institution also includes branches and agencies of foreign banks and any other types of financial institutions and entities supervised by the Federal Reserve System. The term "board of directors" will be interchangeable with references to the "senior management" of branches and agencies of foreign banks.

management portion is a discussion of the basic "customer-due-diligence" (CDD) principle that is the foundation for the safe and sound operation of a private-banking business. The "Preparation for Inspection" subsection assists in defining the inspection scope and provides a list of core requests to be made in the first-day letter. Additional inspection and examination guidance can be found in this manual, the Federal Financial Institutions Examination Council's (FFIEC) *Bank Secrecy Act/Anti–Money Laundering (BSA/AML) Examination Manual* (see SR-05-12), the Federal Reserve System's *Trust Examination Manual* and its *Trading and Capital-Markets Activities Manual,* and in the FFIEC's *Information Technology Examination Handbook.*

In reviewing specific functional and product-inspection procedures (as found in the private-banking activities module that is part of the framework for risk-focused supervision of large complex institutions), all aspects of the private-banking review should be coordinated with the rest of the inspection to eliminate unnecessary duplication of effort. Furthermore, this section has introduced the review of trust activities and fiduciary services, critical components of most private-banking operations, as part of the overall private-banking review. Although the product nature of these activities differs from that of products generated by other banking activities, such as lending and deposit taking, the functional components of private banking (supervision and organization, risk management, operational controls and management information systems, audit, compliance, and financial condition/business profile) should be reviewed across product lines.

Private banking offers the personal and discrete delivery of a wide variety of financial services and products to an affluent market, primarily to high net worth individuals and their corporate interests. A private-banking operation typically offers its customers an all-inclusive money-management relationship, including investment portfolio management, financial-planning advice, offshore facilities, custodial services, funds transfer, lending services, overdraft privileges, hold mail, letter-of-credit financing, and bill-paying services. As the affluent market grows, both in the United States and globally, competition to serve it is becoming more intense. Consequently, the private-banking marketplace includes banks, nonbanks, and other types of banking organizations and financial institutions. Private-banking products, services, technologies, and distribution channels are still evolving. A range of private-banking products and services may be offered to customers throughout an institution's global network of affiliated entities—including branches, subsidiaries, and representative offices—in many different regions of the world, including offshore secrecy jurisdictions.

Typically, private-banking customers are high net worth individuals or institutional investors who have minimum investible assets of $1 million or more. Institutions often differentiate domestic from international private banking, and they may further segregate the international function on the basis of the geographic location of their international client base. International private-banking clients may be wealthy individuals who live in politically unstable nations and are seeking a safe haven for their capital. Therefore, obtaining detailed background information and documentation about the international client may be more difficult than it is for the domestic customer. Private-banking accounts may, for example, be opened in the name of an individual, a commercial business, a law firm, an investment adviser, a trust, a personal investment company (PIC), or an offshore mutual fund.

In 2001, the USA Patriot Act (the Patriot Act) established new and enhanced measures to prevent, detect, and prosecute money laundering and terrorist financing. In general, these measures were enacted through amendments to the Bank Secrecy Act (BSA). The measures directly affecting banking organizations are implemented primarily through regulations issued by the U.S. Department of the Treasury (31 C.F.R. 103).[2] Section 326 of the Patriot Act (see the BSA at 31 U.S.C. 5318(*l*)) requires financial institutions (such as banks, savings associations, trust companies, and credit unions) to have customer identification programs that include measures to—

1. require that certain information be obtained at account opening (for individuals, the information would generally include their name, address, tax identification number, and date of birth);

2. For banking organizations, the regulation implementing the requirements of section 326 of the Patriot Act was jointly issued by the U.S. Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the National Credit Union Administration.

2. verify the identity of new account holders within a reasonable time period;
3. ensure that a banking organization has a reasonable belief that it knows each customer's identity;
4. maintain records of the information used to verify a person's identity; and
5. compare the names of new customers against government lists of known or suspected terrorists or terrorist organizations.

A customer identification program is an important component of a financial institution's overall anti-money-laundering and BSA compliance program.

SR-04-13 disseminated the interagency BSA examination procedures that should be used to evaluate banking organizations' compliance with the regulation. The scope of the examination or inspection can be tailored to the reliability of the banking organization's compliance-management system and to the level of risk that the organization assumes. Relevant interagency guidance (in a frequently-asked-question format) has been issued to address the customer identification program rules. (See SR-05-9.)

Private-banking accounts are usually generated on a referral basis. Every client of a private-banking operation is assigned a salesperson or marketer, commonly known as a relationship manager (RM), as the primary point of contact with the institution. The RM is generally charged with understanding and anticipating the needs of his or her wealthy clients, and then recommending services and products for them. The number of accounts an RM handles varies, depending on the portfolio size or net worth of the particular accounts. RMs strive to provide a high level of support, service, and investment opportunities to their clients and tend to maintain strong, long-term client relationships. Frequently, RMs take accounts with them to other private-banking institutions if they change employment. Historically, initial and ongoing due diligence of private-banking clients is not always well documented in the institution's files because of RM turnover and confidentiality concerns.

Clients may choose to delegate a great deal of authority and discretion over their financial affairs to RMs. Given the close relationship between clients and their account officers, an integral part of the inspection process is assessing the adequacy of managerial oversight of the nature and volume of transactions conducted within the private-banking department or with other departments of the financial institution, as well as determining the adequacy and integrity of the RM's procedures. Policy guidelines and management supervision should provide parameters for evaluating the appropriateness of all products, especially those involving market risk. Moreover, because of the discretion given to RMs, management should develop effective procedures to review the activity of client accounts in order to protect the client from any unauthorized activity. In addition, ongoing monitoring of account activity should be conducted to detect activity that is inconsistent with the client profile (for example, frequent or sizable unexplained transfers flowing through the account).

Finally, as clients develop a return-on-assets (ROA) outlook to enhance their returns, the use of leveraging and arbitrage is becoming more evident in the private-banking business. Examiners should be alert to the totality of the client relationship product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

2010.11.1.1 Products and Services

2010.11.1.1.1 Personal Investment Companies, Offshore Trusts, and Token-Name Accounts

Private-banking services almost always involve a high level of confidentiality for clients and their account information. Consequently, it is not unusual for private bankers to help their clients achieve their financial-planning, estate-planning, and confidentiality goals through offshore vehicles such as personal investment companies (PICs), trusts, or more exotic arrangements, such as hedge fund partnerships. While these vehicles may be used for legitimate reasons, without careful scrutiny, they may camouflage illegal activities. Private bankers should be committed to using sound judgment and enforcing prudent banking practices, especially when they are assisting clients in establishing offshore vehicles or token-name accounts.

Through their global network of affiliated entities, private banks often form PICs for their clients. These "shell" companies, which are incorporated in offshore secrecy jurisdictions such as the Cayman Islands, Channel Islands, Bahamas, British Virgin Islands, and Netherlands Antilles, are formed to hold the customer's assets as well as offer confidentiality by opening accounts in the PIC's name. The "beneficial owners" of the shell corporations are

typically foreign nationals. The banking institution should know and be able to document that it knows the beneficial owners of such corporations and that it has performed the appropriate due diligence to support these efforts. Emphasis should be placed on verifying the source or origin of the customer's wealth. Similarly, offshore trusts established in these jurisdictions should identify grantors of the trusts and sources of the grantors' wealth. *Anonymous relationships or relationships in which the RM does not know and document the beneficial owner should not be permitted.*

PICs are typically passive personal investment vehicles. However, foreign nationals have established PICs as operating accounts for business entities they control in their home countries. Accordingly, financial institutions should use extra care when dealing with beneficial owners of PICs and associated trusts; these vehicles can be used to conceal illegal activities.

2010.11.1.1.2 Deposit-Taking Activities of Subsidiary Institutions

A client's private-banking relationship frequently begins with a deposit account and then expands into other products. In fact, many institutions require private-banking customers to establish a deposit account before maintaining any other accounts. Deposit accounts serve as conduits for a client's money flows. To distinguish private-banking accounts from retail accounts, institutions usually require significantly higher minimum account balances and assess higher fees. The private-banking function or institution should have account-opening procedures and documentation requirements that must be fulfilled before a deposit account can be opened. (These standards are described in detail in the "Functional Review" subsection.)

Most private banks offer a broad spectrum of deposit products, including multicurrency deposit accounts that are used by clients who engage in foreign-exchange, securities, and derivatives transactions. The client's transaction activity, such as wire transfers, check writing, and cash deposits and withdrawals, is conducted through deposit accounts (including current accounts). It is very important that the transaction activity into and out of these deposit accounts (including internal transfers between affiliated deposit accounts) be closely monitored for suspicious transactions that are inconsistent with the client's profile of usual transactions.

Suspicious transactions could warrant the filing of a Suspicious Activity Report (SAR). A bank holding company or any nonbank subsidiary thereof, or a foreign bank that is subject to the Bank Holding Company Act (or any nonbank subsidiary of such a foreign bank operating in the United States), is required to file a SAR in accordance with the provision of section 208.62 of the Federal Reserve Board's Regulation H (12 C.F.R. 208.62) when suspicious transactions or activities are initially discovered and warrant or require reporting. See the reporting requirements discussed in subsection 2010.11.2.2.1.1; SR-03-12 and its attached July 2003 SAR form and instructions; and the expanded examination procedures for private banking in the FFIEC's *BSA/AML Examination Manual.*

2010.11.1.1.3 Investment Management

In private banking, investment management usually consists of two types of accounts: (1) discretionary accounts in which portfolio managers make the investment decisions on the basis of recommendations from the bank's investment research resources and (2) nondiscretionary (investment advisory) accounts in which clients make their own investment decisions when conducting trades. For nondiscretionary clients, the banks typically offer investment recommendations subject to the client's written approval. Discretionary accounts consist of a mixture of instruments bearing varying degrees of market, credit, and liquidity risk that should be appropriate to the client's investment objectives and risk appetite. Both account types are governed under separate agreements between the client and the institution.

Unlike depository accounts, securities and other instruments held in the client's investment accounts are not reflected on the balance sheet of the institution because they belong to the client. These managed assets are usually accounted for on a separate ledger that is segregated according to the customer who owns the assets. For regulatory reporting, domestic trust departments and foreign trust departments of U.S. banks are required to report trust assets annually using FFIEC Form 001 (Annual Report of Trust Assets) and FFIEC Form 006 (Annual Report of International Fiduciary Activities). On the other hand, the fiduciary activities of foreign banking organizations operating in the United States currently are not reported on any FFIEC regulatory report.

2010.11.1.1.4 Credit

Private-banking clients may request extensions of credit on either a secured or an unsecured basis. Loans backed by cash collateral or managed assets held by the private-banking function are quite common, especially in international private banking. Private-banking clients may pledge a wide range of their assets, including cash, mortgages, marketable securities, land, or buildings, to securitize their loans. Management should demonstrate an understanding of the purpose of the credit, the source of repayment, the loan tenor, and the collateral used in the financing. When lending to individuals with high net worths, whether on a secured or an unsecured basis, the creditworthiness determination is bolstered by a thorough and well-structured customer-due-diligence process. If that process is not thorough, collateral derived from illicit activities may be subject to government forfeiture.

Borrowing mechanisms are sometimes established to afford nonresident-alien customers the ability to keep financial assets in the United States and to use such assets (via collateralized borrowing arrangements) to provide operating capital for businesses they own and operate in their home countries. Such arrangements enable these customers to keep the existence of these financial assets secret from their home-country authorities and others, while they continue to use the funds (via collateralized borrowings) to fund their businesses at home.

Private bankers need to maintain in the United States adequate CDD information on such nonresident-alien customers and their primary business interests. A well-documented CDD file may include information on the customer from "who's who" and similar services, Internet research, foreign tax returns and financial statements, checks conducted by the Office of Foreign Assets Control (OFAC), and written and appropriately documented Call Reports prepared by the RM.

While these lending mechanisms may be used for legitimate reasons, management needs to determine whether the arrangements are being used primarily to obfuscate the beneficial ownership of collateral assets, making it difficult for the customer's home-country government to identify who owns the assets. If so, management needs to further determine whether the practice varies from both the appropriate standards of international cooperation for transparency issues and with prudent banking practices, and if so, whether the institution is exposed to elevated legal risk.

2010.11.1.1.5 Payable-Through Accounts

Another product that may be available in private-banking operations is payable-through accounts (PTAs). PTAs are transaction deposit accounts through which U.S. banking entities ("payable-through banks") extend check-writing privileges to the customers of a foreign bank. The foreign bank ("master account holder") opens a master checking account with the U.S. bank and uses this account to provide its customers with access to the U.S. banking system. The master account is divided into "subaccounts," each in the name of one of the foreign bank's customers. The foreign bank extends signature authority on its master account to its own customers, who may not be known to the U.S. bank. Consequently, the U.S. bank may have customers who have not been subject to the same account-opening requirements imposed on its U.S. account holders. These subaccount customers are able to write checks and make deposits at the U.S. banking entity. The number of subaccounts permitted under this arrangement may be virtually unlimited.

U.S. banking entities engage in PTAs primarily because they attract dollar deposits from the domestic market of their foreign correspondents without changing the primary bank-customer relationship; PTAs also provide substantial fee income. Generally, PTAs at U.S. banking entities have the following characteristics: they are carried on the U.S. banking entity's books as a correspondent bank account, their transaction volume is high, checks passing through the account contain wording similar to "payable through XYZ bank," and the signatures appearing on checks are not those of authorized officers of the foreign bank. See the expanded examination procedures for PTAs in the FFIEC's *BSA/AML Examination Manual.*

2010.11.1.1.6 Personal Trust and Estates

In trust and estate accounts, an institution offers management services for a client's assets. When dealing with trusts under will, or "testamentary trusts," the institution may receive an estate appointment (executor) and a trustee appointment if the will provided for the trust from the probate. These accounts are fully funded at origination with no opportunity for an outside party to add to the account, and all activities are

subject to review by the probate or surrogates' court. On the other hand, with living trusts, or "grantor trusts," the customer (grantor) may continually add to and, in some instances, has control over the corpus of the account. Trusts and estates require experienced attorneys, money managers, and generally well-rounded professionals to set up and maintain the accounts. In certain cases, bankers may need to manage a customer's closely held business or sole proprietorship. In the case of offshore trust facilities, recent changes in U.S. law have imposed additional obligations on those banks that function as trustees or corporate management for offshore trusts and PICs.

A critical element in offering personal trust and estate services is the fiduciary responsibility of the institutions to their customers. This responsibility requires that institutions always act in the best interest of the clients pursuant to the trust documentation, perhaps even to the detriment of the bank. In these accounts, the bank is the fiduciary and the trust officer serves as a representative of the institution. Fiduciaries are held to higher standards of conduct than other bankers. Proper administration of trusts and estates includes strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. See the expanded procedures for trust and asset management services in the FFIEC's *BSA/AML Examination Manual.*

2010.11.1.1.7 Custody Services

Custodial services offered to private-banking customers include securities safekeeping, receipt and disbursement of dividends and interest, recordkeeping, and accounting. Custody relationships can be established in many ways, including by referrals from other departments in the bank or from outside investment advisers. The customer or a designated financial adviser retains full control of the investment management of the property subject to the custodianship. Sales and purchases of assets are made by instruction from the customer, and cash disbursements are prearranged or as instructed. Custody accounts involve no investment supervision and no discretion. However, the custodian may be responsible for certain losses if it fails to act properly according to the custody agreement. Therefore, procedures for proper administration should be established and reviewed.

An escrow account is a form of custody account in which the institution agrees to hold cash or securities as a middleman, or a third party. The customer, for example, an attorney or a travel agency, gives the institution funds to hold until the ultimate receiver of the funds "performs" in accordance with the written escrow agreement, at which time the institution releases the funds to the designated party.

2010.11.1.1.8 Funds Transfer

Funds transfer, another service offered by private-banking functions, may involve the transfer of funds between third parties as part of bill-paying and investment services on the basis of customer instructions. The adequacy of controls over funds-transfer instructions that are initiated electronically or telephonically, such as by facsimile machine, telex, telegram, and telephone, is extremely important. Funds-transfer requests are quickly processed and, as required by law, funds-transfer personnel may have limited knowledge of the customers or the purpose of the transactions. Therefore, strong controls and adequate supervision over this area are critical.

2010.11.1.1.9 Hold Mail, No Mail, and Electronic-Mail Only

Hold-mail, no-mail, or electronic-mail-only accounts are often provided to private-banking customers who elect to have bank statements and other documents maintained at the institution or e- mailed to them, rather than mailed to their residence. Agreements for hold-mail accounts should be in place, and the agreements should indicate that it was the customer's choice to have the statements retained at the bank and that the customer will pick up his or her mail at least annually. Variations of hold-mail services include delivery of mail to a prearranged location (such as another branch of the bank) by special courier or the bank's pouch system.

2010.11.1.1.10 Bill-Paying Services

Bill-paying services are often provided to private-banking customers for a fee. If this service is provided, an agreement between the bank and the customer should exist. Typically, a customer may request that the bank debit a deposit

account for credit card bills, utilities, rent, mortgage payments, or other monthly consumer charges. In addition, the increased use of the Internet has given rise to the *electronic-mail-only account,* whereby customers elect to have statements, notices, etc., sent to them only by e-mail.

2010.11.2 FUNCTIONAL REVIEW

When discussing the functional aspects of a private-banking operation, *functional* refers to managerial processes and procedures, such as reporting lines, quality of supervision (including involvement of the board of directors), information flows, policies and procedures, risk-management policies and methodologies, segregation of duties, management information systems, operational controls (including BSA/AML monitoring), and audit coverage. The examiner should be able to draw sound conclusions about the quality and culture of management and stated private-banking policies after reviewing the functional areas described below. Specifically, the institution's risk-identification process and risk appetite should be carefully defined and assessed. Additionally, the effectiveness of the overall control environment maintained by management should be evaluated by an internal or external audit. The effectiveness of the following functional areas is critical to any private-banking operation, regardless of its size or product offerings.

2010.11.2.1 Supervision and Organization

As part of the examiner's appraisal of an organization, the quality of supervision of private-banking activities is evaluated. The appraisal of management covers the full range of functions and activities related to the operation of the private bank. The discharge of responsibilities by bank directors should be effected through an organizational plan that accommodates the volume and business services handled, local business practices and the bank's competition, and the growth and development of the institution's private-banking business. Organizational planning is the joint responsibility of senior bank and private-bank management, should be integrated with the long-range plan for the institution, and should be consistent with any enterprise-wide risk-management program.

Both the directors and management have important roles in formulating policies and establishing programs for private-banking products, operations, internal controls, and audits. However, management alone must implement policies and programs within the organizational framework instituted by the board of directors.

2010.11.2.2 Risk Management

Sound risk-management processes and strong internal controls are critical to safe and sound banking generally and to private-banking activities in particular. Management's role in ensuring the integrity of these processes has become increasingly important as new products and technologies are introduced. Similarly, the client-selection, documentation, approval, and account-monitoring processes should adhere to sound and well-identified practices.

The quality of risk-management practices and internal controls is given significant weight in the evaluation of management and the overall condition of private-banking operations. A bank's failure to establish and maintain a risk-management framework that effectively identifies, measures, monitors, and controls the risks associated with products and services should be considered unsafe and unsound conduct. Furthermore, well-defined management practices should indicate the types of clients that the institution will and will not accept and should establish multiple and segregated levels of authorization for accepting new clients. Institutions that follow sound practices will be better positioned to design and deliver products and services that match their clients' legitimate needs, while reducing the likelihood that unsuitable clients might enter their client account base. Deficiencies noted in this area are weighted in context of the relative risk they pose to the institution and are appropriately reflected in the appraisal of management.

The private-banking function is exposed to a number of risks, including reputational, fiduciary, legal, credit, operational, and market. A brief description of some of the different types of risks follows:

1. *Reputational risk* is the potential that negative publicity regarding an institution's business practices and clients, whether true or not, could cause a decline in the customer base, costly litigation, or revenue reductions.
2. *Fiduciary risk* refers to the risk of loss due to the institution's failure to exercise loyalty; safeguard assets; and, for trusts, to use assets

productively and according to the appropriate standard of care. This risk generally exists in an institution to the extent that it exercises discretion in managing assets on behalf of a customer.

3. *Legal risk* arises from the potential of unenforceable contracts, client lawsuits, or adverse judgments to disrupt or otherwise negatively affect the operations or condition of a banking organization. One key dimension of legal risk is supervisory action that could result in costly fines or other punitive measures being levied against an institution for compliance breakdowns.
4. *Credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation.
5. *Operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses.

Although effective management of all of the above risks is critical for an institution, certain aspects of reputational, legal, and fiduciary risks are often unique to a private-banking function. In this regard, the following customer-due-diligence policies and practices are essential in the management of reputational and legal risks in the private-banking functions. (In addition, sound fiduciary practices and conflicts-of-interest issues that a private-banking operation may face in acting as fiduciary are described in the subsection on fiduciary standards.)

2010.11.2.2.1 Customer-Due-Diligence Policy and Procedures

Sound customer-due-diligence (CDD) policies and procedures are essential to minimize the risks inherent in private banking. The policies and procedures should clearly describe the target client base in terms such as "minimum investable net worth" and "types of products sought," as well as specifically indicate the type of clientele the institution will or will not accept. Policies and procedures should be designed to ensure that effective due diligence is performed on all potential clients, that client files are bolstered with additional CDD information on an ongoing basis, and that activity in client accounts is monitored for transactions that are inconsistent with the client profile and may constitute unlawful activities, such as money laundering. The client's identity, background, and the nature of his or her transactions should be documented and approved by the back office before opening an account or accepting client monies. Certain high-risk clients like foreign politicians or money exchange houses should have additional documentation to mitigate their higher risk.

Money laundering is associated with a broad range of illicit activities: the ultimate intention is to disguise the money's true source—from the initial placement of illegally derived cash proceeds to the layers of financial transactions that disguise the audit trail—and make the funds appear legitimate. Under U.S. money-laundering statutes, a bank employee can be held personally liable if he or she is deemed to engage in "willful blindness." This condition occurs when the employee fails to make reasonable inquiries to satisfy suspicions about client account activities.

Since the key element of an effective CDD policy is a comprehensive knowledge of the client, the bank's policies and procedures should clearly reflect the controls needed to ensure the policy is fully implemented. CDD policies should clearly delineate the accountability and authority for opening accounts and for determining if effective CDD practices have been performed on each client. In addition, policies should delineate documentation standards and accountability for gathering client information from referrals among departments or areas within the institution as well as from accounts brought to the institution by new RMs.

In carrying out prudent CDD practices on potential private-banking customers, management should document efforts to obtain and corroborate critical background information. Private-banking employees abroad often have local contacts who can assist in corroborating information received from the customer. The information listed below should be corroborated by a reliable, independent source, when possible:

1. The customer's current address and telephone number for his or her primary residence, which should be corroborated at regular intervals, can be verified through a variety of methods, such as—
   a. visiting the residence, office, factory, or farm (with the RM recording the results of the visit or conversations in a memorandum);
   b. checking the information against the telephone directory; the client's residence, as

indicated on his or her national ID card; a mortgage or bank statement or utility or property tax bill; or the electoral or tax rolls;
c. obtaining a reference from the client's government or known employer or from another bank;
d. checking with a credit bureau or professional corroboration organization; or
e. any other method verified by the RM.

2. Sufficient business information about the customer should be gathered so that the RM understands the profile of the customer's commercial transactions. This information should include a description of the nature of the customer's business operations or means of generating income, primary trade or business areas, and major clients and their geographic locations, as well as the primary business address and telephone number. These items can be obtained through a combination of any of the following sources:
   a. a visit to the office, factory, or farm
   b. a reliable third party who has a business relationship with the customer
   c. financial statements
   d. Dun and Bradstreet reports
   e. newspaper or magazine articles
   f. Lexis/Nexis reports on the customer or customer's business
   g. "Who's Who" reports from the home country
   h. private investigations
3. Although it is often not possible to get proof of a client's wealth, an RM can use his or her good judgment to derive a reasonable estimate of the individual's net worth.
4. As part of the ongoing CDD process, the RM should document in memos or "call reports" the substance of discussions that take place during frequent visits with the client. Additional information about a client's wealth, business, or other interests provides insight into potential marketing opportunities for the RM and the bank, and updates and strengthens the CDD profile.

As a rule, most private banks make it a policy not to accept walk-in clients. If an exception is made, procedures for the necessary documentation and approvals supporting the exception should be in place. Similarly, other exceptions to policy and procedures should readily identify the specific exception and the required due-diligence and approval process for overriding existing procedures.

In most instances, all CDD information and documentation should be maintained and available for examination and inspection at the location where the account is located or where the financial services are rendered. If the bank maintains centralized customer files in locations other than where the account is located or the financial services are rendered, complete customer information, identification, and documentation must be made available at the location where the account is located or where the financial services are rendered within 48 hours of a Federal Reserve examiner's request. Off-site storage of CDD information will be allowed only if the bank has adopted, as part of its customer-due-diligence program, specific procedures designed to ensure that (1) the accounts are subject to ongoing Office of Foreign Assets Control screening that is equivalent to the screening afforded other accounts, (2) the accounts are subject to the same degree of review for suspicious activity, and (3) the bank demonstrates that the appropriate review of the information and documentation is being performed by personnel at the offshore location.

CDD procedures should be no different when the institution deals with a financial adviser or other type of intermediary acting on behalf of a client. To perform its CDD responsibilities when dealing with a financial adviser, the institution should identify the beneficial owner of the account (usually the intermediary's client, but in rare cases, it is the intermediary itself) and perform its CDD analysis with respect to that beneficial owner. The imposition of an intermediary between the institution and counterparty should not lessen the institution's CDD responsibilities.

The purpose of all private-banking relationships should also be readily identified. Incoming customer funds may be used for various purposes, such as establishing deposit accounts, funding investments, or establishing trusts. The bank's CDD procedures should allow for the collection of sufficient information to develop a transaction or client profile for each customer, which will be used in analyzing client transactions. Internal systems should be developed for monitoring and identifying transactions that may be inconsistent with the transaction or client profile for a customer and which may thus constitute suspicious activity.

2010.11.2.2.1.1 Suspicious Activity Reports

The proper and timely filing of Suspicious Activity Reports (SARs) is an important compo-

nent of a bank's CDD program. Since 1996, the federal financial institution supervisory agencies and the Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) have required banking organizations to report known or suspected violations of law as well as suspicious transactions on a SAR. See the Board's SAR regulation (Regulation H, section 208.62 [12 C.F.R. 208.62] and Regulation Y, section 225.4(f) [12 C.F.R. 225.4(f)]).[3] Law enforcement agencies use the information reported on the form to initiate investigations, and Federal Reserve staff use the SAR information in their examination and oversight of supervised institutions.

A member bank and a BHC are required to file a SAR with the appropriate federal law enforcement agencies and the Department of the Treasury. A SAR must be prepared in accordance with the form's instructions. (See SR-03-12 and the attached July 2003 SAR form and instructions.) The completed SAR is to be sent to FinCEN when an institution detects—

1. insider abuse involving any amount;
2. violations aggregating $5,000 or more in which a suspect can be identified;
3. violations aggregating $25,000 or more regardless of a potential suspect; or
4. transactions aggregating $5,000 or more that involve potential money laundering or violations of the Bank Secrecy Act.

When a SAR is filed, the management of a member bank must promptly notify its board of directors or a committee thereof.

A SAR must be filed within 30 calendar days after the date of initial detection of the facts that may constitute a basis for filing a SAR. If no suspect was identified on the date of detection of the incident requiring the filing, a member bank may delay filing a SAR for an additional 30 calendar days in order to identify the suspect. Reporting may not be delayed more than 60 calendar days after the date of initial detection of a reportable transaction. In situations involving violations requiring immediate attention, such as when a reportable violation is ongoing, the financial institution is required to immediately notify an appropriate law enforcement authority and the Board by telephone, in addition to its timely filing of a SAR.

A banking organization's internal systems for capturing suspicious activities should provide essential information about the nature and volume of activities passing through customer accounts. Any information suggesting that suspicious activity has occurred should be pursued, and, if an explanation is not forthcoming, the matter should be reported to banking organization's management. Examiners should ensure that the institution's approach to SARs is proactive and that well-established procedures cover the SAR process. Accountability should exist within the organization for the analysis and follow-up of internally identified suspicious activity; this analysis should conclude with a decision on the appropriateness of filing a SAR. See SR-03-12 and the attached July 2003 SAR form and instructions. See also the core procedures concerning suspicious-activity-reporting requirements in the FFIEC *BSA/AML Examination Manual.*

2010.11.2.2.2 Credit-Underwriting Standards

The underwriting standards for private-banking loans to high net worth individuals should be consistent with prudent lending standards. The same credit policies and procedures that are applicable to any other type of lending arrangement should extend to these loans. At a minimum, sound policies and procedures should address the following: all approved credit products and services offered by the institution, lending limits, acceptable forms of collateral, geographic and other limitations, conditions under which credit is granted, repayment terms, maximum tenor, loan authority, collections and charge-offs, and prohibition against capitalization of interest.

An extension of credit based solely on collateral, even if the collateral is cash, does not ensure repayment. While the collateral enhances the bank's position, it should not substitute for regular credit analyses and prudent lending practices. If collateral is derived from illegal activities, it is subject to forfeiture through the seizure of assets by a government agency. The bank should perform its due diligence by adequately and reasonably ascertaining and documenting that the funds of its private-banking customers were derived from legitimate means. Banks should also verify that the use of the loan proceeds is for legitimate purposes.

3. The Board's SAR rules apply to state member banks, bank holding companies and their nonbank subsidiaries that do not report on a different SAR form (for example, broker-dealers), Edge and agreement corporations, and the U.S. branches and agencies of foreign banks supervised by the Federal Reserve.

In addition, bank policies should explicitly describe the terms under which ''margin loans,'' loans collateralized by securities, are made and should ensure that they conform to applicable regulations. Management should review and approve daily MIS reports. The risk of market deterioration in the value of the underlying collateral may subject the lender to loss if the collateral must be liquidated to repay the loan. In the event of a ''margin call,'' any shortage should be paid for promptly by the customer from other sources pursuant to the terms of the margin agreement.

In addition, policies should address the acceptance of collateral held at another location, such as an affiliated entity, but pledged to the private-banking function. Under these circumstances, management of the private-banking function should, at a minimum, receive frequent reports detailing the collateral type and current valuation. In addition, management of the private-banking function should be informed of any changes or substitutions in collateral.

2010.11.2.3 Fiduciary Standards

Fiduciary risk is managed through the maintenance of an effective and accountable committee structure; retention of technically proficient staff; and development of effective policies, procedures, and controls. In managing its fiduciary risk, the bank must ensure that it carries out the following fiduciary duties:

1. *Duty of loyalty.* Trustees are obligated to make all decisions based exclusively on the best interests of trust customers. Except as permitted by law, trustees cannot place themselves in a position in which their interests might conflict with those of the trust beneficiaries.
2. *Avoidance of conflicts of interest.* Conflicts of interest arise in any transaction in which the fiduciary simultaneously represents the interests of multiple parties (including its own interests) that may be adverse to one another. Institutions should have detailed policies and procedures regarding potential conflicts of interest. All potential conflicts identified should be brought to the attention of management and the trust committee, with appropriate action taken. Conflicts of interest may arise throughout an institution. Care should be taken by fiduciary business lines, in particular, to manage conflicts of interest between fiduciary business lines and other business lines (including other fiduciary business lines). Consequently, management throughout the institution should receive training in these matters. For more information on the supervision of fiduciary activities, see section 3120.0 in this manual and section 4200.0 in the *Commercial Bank Examination Manual.*
3. *Duty to prudently manage discretionary trust and agency assets.* Since 1994, the majority of states have adopted laws concerning the prudent investor rule (PIR) with respect to the investment of funds in a fiduciary capacity. PIR is a standard of review that imposes an obligation to prudently manage the portfolio as a whole, focusing on the process of portfolio management, rather than on the outcome of individual investment decisions. Although this rule only governs trusts, the standard is traditionally applied to all accounts for which the institution is managing funds.

2010.11.2.4 Operational Controls

To minimize any operational risks associated with private-banking activities, management is responsible for establishing an effective internal control infrastructure and reliable management information systems. Critical operational controls over any private-banking activity include the establishment of written policies and procedures, segregation of duties, and comprehensive management reporting. Throughout this section, specific guidelines and inspection procedures for assessing internal controls over different private-banking activities are provided. Listed below are some of those guidelines that cover specific private-banking services.

2010.11.2.4.1 Segregation of Duties

Banking organizations should have guidelines on the segregation of employees' duties in order to prevent the unauthorized waiver of documentation requirements, poorly documented referrals, and overlooked suspicious activities. Independent oversight by the back office helps to ensure compliance with account-opening procedures and CDD documentation. Control-conscious institutions may use independent units, such as compliance, risk management, or senior management, to fill this function in lieu of the back office. The audit and compliance

functions of the private-banking entity should be similarly independent so that they can operate autonomously from line management.

2010.11.2.4.2 Inactive and Dormant Accounts

Management should be aware that banking laws in most states prohibit banks from offering services that allow deposit accounts to be inactive for prolonged periods of time (generally, 12 or more months with no externally generated account-balance activity). These regulations are based on the presumption that inactive and dormant accounts may be subject to manipulation and abuse by insiders. Policies and procedures should delineate when inactivity occurs and when inactive accounts should be converted to dormant status. Effective controls over dormant accounts should include a specified time between the last customer-originated activity and its classification as dormant, the segregation of signature cards for dormant accounts, dual control of records, and the blocking of the account so that entries cannot be posted to the account without review by more than one member of senior management.

2010.11.2.4.3 Pass-Through Accounts and Omnibus Accounts

Pass-through accounts (PTAs) extend checking-account privileges to the customers of a foreign bank; several risks are involved in providing these accounts. In particular, if the U.S. banking entity does not exercise the same due diligence and customer vetting for PTAs as it does for domestic account relationships, the use of PTAs may facilitate unsafe and unsound banking practices or illegal activities, including money laundering. Additionally, if accounts at U.S. banking entities are used for illegal purposes, the entities could be exposed to reputational risk and risk of financial loss as a result of asset seizures and forfeitures brought by law enforcement authorities. As stated in SR-95-10, it is recommended that U.S. banking entities terminate a payable-through arrangement with a foreign bank in situations in which (1) adequate information about the ultimate users of PTAs cannot be obtained, (2) the foreign bank cannot be relied on to identify and monitor the transactions of its own customers, or (3) the U.S. banking entity is unable to ensure that its payable-through accounts are not being used for money laundering or other illicit purposes.

Omnibus, or general clearing, accounts may also exist in the private-banking system. They may be used to accommodate client funds before an account opening to expedite a new relationship, or they may fund products such as mutual funds in which client deposit accounts may not be required. However, these accounts could circumvent an audit trail of client transactions. Examiners should carefully review a bank's use of such accounts and the adequacy of its controls on their appropriate use. Generally, client monies should flow through client deposit accounts, which should function as the sole conduit and paper trail for client transactions.

2010.11.2.4.4 Hold-Mail, No-Mail, and E-Mail-Only Controls

Controls over hold-mail, no-mail, and e-mail-only accounts are critical because the clients have relinquished their ability to detect unauthorized transactions in their accounts in a timely manner. Accounts with high volume or significant losses warrant further inquiry. Hold-mail, no-mail, and e-mail-only account operations should ensure that client accounts are subject to dual control and are reviewed by an independent party.

2010.11.2.4.5 Funds Transfer—Tracking Transaction Flows

One way that institutions can improve their customer knowledge is by tracking the transaction flows into and out of customer accounts and payable-through subaccounts. Tracking should include funds-transfer activities. Policies and procedures to detect unusual or suspicious activities should identify the types of activities that would prompt staff to investigate the customer's activities and should provide guidance on the appropriate action required for suspicious activity. The following is a checklist to guide bank personnel in identifying some potential abuses:

1. indications of frequent overrides of established approval authority or other internal controls
2. intentional circumvention of approval authority by splitting transactions
3. wire transfers to and from known secrecy jurisdictions

4. frequent or large wire transfers for persons who have no account relationship with the bank, or funds being transferred into and out of an omnibus or general clearing account instead of the client's deposit account
5. wire transfers involving cash amounts in excess of $10,000
6. inadequate control of password access
7. customer complaints or frequent error conditions

2010.11.2.4.6 Custody—Detection of "Free Riding"

Custody departments should monitor account activity to detect instances of "free-riding," the practice of offering the purchase of securities without sufficient capital and then using the proceeds of the sale of the same securities to cover the initial purchase. Free-riding poses significant risk to the institution and typically occurs without the bank's prior knowledge. Free-riding also violates margin rules (Regulations T, U, and X) governing the extension of credit in connection with securities transactions. (See SR-93-13 and section 2187.0.)

2010.11.2.5 Management Information Systems

Management information systems (MIS) should accumulate, interpret, and communicate information on (1) the private-banking assets under management, (2) profitability, (3) business and transaction activities, and (4) inherent risks. The form and content of MIS for private-banking activities will be a function of the size and complexity of the private-banking organization. Accurate, informative, and timely reports that perform the following functions may be prepared and reviewed by RMs and senior management:

1. aggregate the assets under management according to customer, product or service, geographic area, and business unit
2. attribute revenue according to customer and product type
3. identify customer accounts that are related to or affiliated with one another through common ownership or common control
4. identify and aggregate customer accounts by source of referral
5. identify beneficial ownership of trust, PIC, and similar accounts

To monitor and report transaction activity and to detect suspicious transactions, management reports may be developed to—

1. monitor a specific transaction criterion, such as a minimum dollar amount or volume or activity level;
2. monitor a certain type of transaction, such as one with a particular pattern;
3. monitor individual customer accounts for variations from established transaction and activity profiles based on what is usual or expected for that customer; and
4. monitor specific transactions for BSA and SAR compliance.

In addition, reports prepared for private-banking customers should be accurate, timely, and informative. Regular reports and statements prepared for private-banking customers should adequately and accurately describe the application of their funds and should detail all transactions and activity that pertain to the customers' accounts.

Furthermore, MIS and technology play a role in building new and more direct channels of information between the institution and its private-banking customers. Active and sophisticated customers are increasing their demand for data relevant to their investment needs, which is fostering the creation of online information services. Online information can satisfy customers' desire for convenience, real-time access to information, and a seamless delivery of information.

2010.11.2.6 Audit

An effective audit function is vital to ensuring the strength of a private bank's internal controls. As a matter of practice, internal and external auditors should be independently verifying and confirming that the framework of internal controls is being maintained and operated in a manner that adequately addresses the risks associated with the activities of the organization. Critical elements of an effective internal audit function are the strong qualifications and expertise of the internal audit staff and a sound risk-assessment process for determining the scope and frequency of specific audits. The audit process should be risk-focused and should ultimately determine the risk rating of business lines and client CDD procedures. Compliance with CDD policies and procedures and the

detailed testing of files for CDD documentation are also key elements of the audit function. Finally, examiners should review and evaluate management's responsiveness to criticisms by the audit function.

2010.11.2.7 Compliance

The responsibility for ensuring effective compliance with relevant laws and regulations may vary among different forms of institutions, depending on their size, complexity, and availability of resources. Some institutions may have a distinct compliance department with the centralized role of ensuring compliance institution-wide, including private-banking activities. This arrangement is strongly preferable to a situation in which an institution delegates compliance to specific functions, which may result in the management of private-banking operations being responsible for its own internal review. Compliance has a critical role in monitoring private-banking activities; the function should be independent of line management. In addition to ensuring compliance with various laws and regulations such as the Bank Secrecy Act and those promulgated by the Office of Foreign Assets Control, compliance may perform its own internal investigations and due diligence on employees, customers, and third parties with whom the bank has contracted in a consulting or referral capacity and whose behavior, activities, and transactions appear to be unusual or suspicious. Institutions may also find it beneficial for compliance to review and authorize account-opening documentation and CDD adequacy for new accounts. The role of compliance is a control function, but it should not be a substitute for regular and frequent internal audit coverage of the private-banking function. Following is a description of certain regulations that may be monitored by the compliance function.

2010.11.2.7.1 Office of Foreign Assets Control

The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals. Sanctions are imposed against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC acts under presidential wartime and national emergency powers, as well as under authority granted by specific legislation, to impose controls on transactions and freeze foreign assets under U.S. jurisdiction. Many of the sanctions are based on United Nations and other international mandates, are multilateral in scope, and involve close cooperation with allied governments. Under the International Emergency Economic Powers Act, the President can impose sanctions, such as trade embargoes, the freezing of assets, and import surcharges, on certain foreign countries and the "specially designated nationals" of those countries.

A "specially designated national" is a person or entity who acts on behalf of one of the countries under economic sanction by the United States. Dealing with such nationals is prohibited. Moreover, their assets or accounts in the United States are frozen. In certain cases, the Treasury Department can issue a license to a designated national. This license can then be presented by the customer to the institution, allowing the institution to debit his or her account. The license can be either general or specific.

OFAC screening may be difficult when transactions are conducted through PICs, token names, numbered accounts, or other vehicles that shield true identities. Management must ensure that accounts maintained in a name other than that of the beneficial owner are subject to the same level of filtering for OFAC specially designated nationals and blocked foreign countries as other accounts. That is, the OFAC screening process must include the account's beneficial ownership as well as the official account name.

Any violation of regulations implementing designated national sanctions subjects the violator to criminal prosecution, including up to 12 years in prison and $1 million in corporate fines and $250,000 in individual fines, per incident. Any funds frozen because of OFAC orders should be placed in a blocked account. Release of those funds cannot occur without a license from the Treasury Department.

2010.11.2.7.2 Bank Secrecy Act

Guidelines for compliance with the Bank Secrecy Act (BSA) can be found in the FFIEC *BSA/AAML Examination Manual.* See also SR-04-13, SR-03-17, SR-01-29 (the customer identification program requirements), and the

question-and-answer format interpretations (SR-05-9) of the U.S. Department of the Treasury's regulation (31 C.F.R. 103) for banking organizations, which is based on section 326 of the Patriot Act. In addition, the procedures for conducting BSA examinations of foreign offices of U.S. banks are detailed in SR-96-5. The SAR filing requirements for nonbank subsidiaries of bank holding companies and state member banks are also set forth in SR-02-24.

2010.11.3 PREPARATION FOR INSPECTION

The following subsections provide examiners with guidance on preparing for the on-site inspection of private-banking operations, including determination of the inspection scope and drafting of the first-day-letter questionnaire that is provided to the institution.

2010.11.3.1 Pre-Inspection Review

To prepare the examiners for their assignments and to determine the appropriate staffing and scope of the inspection, the following guidelines should be followed during the pre-inspection planning process:

1. Review the prior report of inspection and workpapers for the inspection scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior inspection. The prior inspection report and inspection plan should also provide insight to key contacts at the institution and to the time frame of the prior private-banking review.
2. Obtain relevant correspondence sent since the prior inspection, such as management's response to the report of inspection, any applications submitted to the Federal Reserve, and any supervisory action.
3. Research press releases and published news stories about the institution and its private-banking activities.
4. Review internal and external audit reports and any internal risk assessments performed by the institution on its private-banking activities. Such reports should include an assessment of the internal controls and risk profile of the private-banking function.
5. Contact the institution's management to ascertain what changes have occurred since the last inspection or are planned in the near future. For example, examiners should determine if there have been changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered. If there is no mention of private banking in the prior inspection report, management should be asked at this time if they have commenced or plan to commence any private-banking activities.
6. Follow these inspection procedures and also consider the core examination procedures in the FFIEC *BSA/AML Examination Manual* in order to establish the base scope for the inspection of private-banking activities. Review and follow the expanded procedures for private banking and any other expanded procedures that are deemed necessary.

2010.11.3.2 Inspection Staffing and Scope

Once the inspection scope has been established and before beginning the new inspection, the examiner-in-charge and key administrators of the inspection team should meet to discuss the private-banking inspection scope, the assignments of the functional areas of private banking, and the supplemental reviews of specific private-banking products and services. If the bank's business lines and services overlap and if its customer base and personnel are shared throughout the organization, examiners may be forced to go beyond a rudimentary review of private-banking operations. They will probably need to focus on the policies, practices, and risks within the different divisions of a particular institution and throughout the institution's global network of affiliated entities.

2010.11.3.3 Reflection of Organizational Structure

The review of private-banking activities should be conducted on the basis of the bank holding company's organizational structure. These structures may vary considerably depending on the size and sophistication of the institution, its country of origin and the other geographic markets in which it competes, and the objectives and strategies of its management and board of directors. To the extent possible, examiners should understand the level of consolidated private-banking activities an institution con-

ducts in the United States and abroad. This broad view is needed to maintain the "big picture" impact of private banking for a particular institution.

For bank holding company inspections, examiners must consider the provisions of the Gramm-Leach Bliley Act, which amended section 5(c) of the Bank Holding Company Act, that concern examinations and inspections. In particular, examiners must adhere to those statutory provisions that pertain to the inspections of bank holding company nobank subsidiaries that are supervised by functional regulators. See section 1040.0.

2010.11.3.4 Risk-Focused Approach

Examiners reviewing the private-banking operations should implement the risk-focused inspection approach. The exam scope and degree of testing of private-banking practices should reflect the degree of risk assumed, prior exam findings on the implementation of policies and procedures, the effectiveness of controls, and an assessment of the adequacy of the internal audit and compliance functions. If initial inquiries into the institution's internal audit and other assessment practices raise doubts about the internal system's effectiveness, expanded analysis and review are required—and examiners should perform more transaction testing. Examiners will usually need to follow the core examination procedures in the FFIEC *BSA/AML Examination Manual,* as well as the expanded procedures for private banking. Other expanded procedures should be followed if circumstances dictate.

2010.11.3.5 First-Day Letter

As part of the inspection preparation, examiners should customize the first-day-letter (FDL) questionnaire to reflect the structure and type of private-banking activities of the institution and the scope of the exam. The following is a list of requests regarding private banking that examiners should consider including in the FDL. Responses to these items should be reviewed in conjunction with responses to the BSA, fiduciary, audit, and internal control inquiries:

1. organizational chart for the private bank on both a functional and legal-entity basis
2. business or strategic plan
3. income and expense statements for the prior fiscal year and current year to date, with projections for the remainder of the current and the next fiscal year, and income by product division and marketing region
4. balance-sheet and total assets under management (list the most active and profitable accounts by type, customer domicile, and responsible account officer)
5. most recent audits for private-banking activities
6. copies of audit committee minutes
7. copy of the CDD and SAR policies and procedures
8. list of all new business initiatives introduced last year and this year, relevant new-product-approval documentation that addresses the evaluation of the unique characteristics and risk associated with the new activity or product, and an assessment of the risk-management oversight and control infrastructures in place to manage the risks
9. list of all accounts in which an intermediary is acting on behalf of clients of the private bank, for example, as financial advisers or money managers
10. explanation of the methodology for following up on outstanding account documentation and a sample report
11. description of the method for aggregating client holdings and activities across business units throughout the organization
12. explanation of how related accounts, such as common control and family link, are identified
13. name of a contact person for information on compensation, training, and recruiting programs for relationship managers
14. list of all personal investment company accounts
15. list of reports that senior management receives regularly on private-banking activities
16. description and sample of the management information reports that monitor account activity
17. description of how senior management monitors compliance with global policies for worldwide operations, particularly for offices operating in secrecy jurisdictions
18. appropriate additional items from the core and expanded procedures for private banking, as set forth in the FFIEC *BSA/AML Examination Manual,* as well as any other items from the expanded procedures that are needed to gauge the adequacy of the

BSA/AML program for private-banking activities.

2010.11.4 INSPECTION OBJECTIVES

1. To determine if the policies, practices, procedures, and internal controls regarding private-banking activities are adequate for the risks involved.
2. To determine if the institution's officers and employees are operating in conformance with established guidelines for conducting private-banking activities.
3. To assess the financial condition and income-generation results of the private-banking activities.
4. To determine the scope and adequacy of the audit function for private-banking activities.
5. To determine compliance with applicable laws and regulations for private banking.
6. To initiate corrective action when policies, practices, procedures, or internal controls are deficient, or when violations of laws or regulations are found.

2010.11.5 INSPECTION PROCEDURES

The examiner-in-charge should supplement the following procedures, as appropriate, with the examination procedures for private banking, as set forth in the FFIEC *BSA/AML Examination Manual.*

2010.11.5.1 Private-Banking Pre-Inspection Procedures

1. As the examiner-in-charge, conduct a meeting with the lead members of the private-banking inspection team and discuss—
   a. the private-banking inspection scope *(The inspection may need to extend beyond a rudimentary review of private-banking operations if the institution's business lines and services overlap and if its customer base and personnel are shared throughout the organization. Examiners will probably need to focus on the policies, practices, and risks within the different divisions of each particular institution and throughout each institution's global network of affiliated entities.);*
   b. examiner assignments of the functional areas of private banking; and
   c. the supplemental reviews of specific private-banking products and services.
2. Review the prior report of inspection and the previous inspection workpapers; description of the inspection scope; structure and type of private-banking activities conducted; and findings, conclusions, and recommendations of the prior inspection. The prior inspection report and inspection plan should also provide information and insight on key contacts at the institution and on the time frame of the prior private-banking review.
3. Review relevant correspondence exchanged since the prior inspection, such as management's response to the report of inspection, any applications submitted to the Federal Reserve, and any supervisory actions.
4. Research press releases and published news stories about the institution and its private-banking activities.
5. Review internal and external audit reports and any internal risk assessments performed by the institution's internal or external auditors on its private-banking activities. Review information on any assessments of the internal controls and risk profile of the private-banking function.
6. Contact management at the institution to ascertain what changes in private-banking services have occurred since the last inspection or if there are any planned in the near future.
   a. Determine if the previous inspection or examination report(s) mention private banking; if not, ask management if they have commenced or plan to commence any private-banking activities within any part of the bank holding company organization.
   b. Determine if there have been any changes to the strategic plan; senior management; or the level and type of private-banking activities, products, and services offered.
   c. During the entire inspection of private-banking activities, be alert to the totality of the client relationship, product by product, in light of increasing client awareness and use of derivatives, emerging-market products, foreign exchange, and margined accounts.

2010.11.5.2 Full-Inspection Phase

1. After reviewing the private-banking functional areas, draw sound conclusions about

the quality and culture of management and stated private-banking policies.

2. Evaluate the adequacy of risk-management policies and practices governing private-banking activities.
3. Assess the organization of the private-banking function and evaluate the quality of management's supervision of private-banking activities. An appraisal of management covers the—
   a. full range of functions (i.e., supervision and organization, risk management, fiduciary standards, operational controls, management information systems, audit, and compliance) and activities related to the operation of the private-banking activities; and
   b. discharge of responsibilities by the institution's directors through a long-range organizational plan that accommodates the volume and business services handled, local business practices and the institution's competition, and the growth and development of the institution's private-banking business.
4. Determine if management has effective procedures for conducting ongoing reviews of client-account activity to detect, and protect the client from, any unauthorized activity and any account activity that is inconsistent with the client's profile (for example, frequent or sizeable unexplained transfers flowing through the account).
5. Determine if the bank holding company has initiated and maintained controls and procedures that require each subsidiary private-banking institution to have account-opening procedures and documentation requirements that must be satisfied before an account can be opened.
6. Determine if the bank holding company requires its subsidiary institutions to maintain and adhere to well-structured CCD procedures.
7. Determine if the bank holding company has proper controls and procedures to ensure each institution's proper administration of trust and estates, including strict controls over assets, prudent investment and management of assets, and meticulous recordkeeping. Review previous trust examination reports and consult with the designated Federal Reserve System trust examiners.
8. Ascertain whether the bank holding company adequately supervises the custody services of its subsidiaries. The bank holding company should ensure that each institution has established and currently maintains procedures for the proper administration of custody services, including the regular review of the services on a preset schedule.
9. Determine whether subsidiary institutions are required to and actually maintain strong controls and supervision over funds transfers.
10. Ascertain if institution management and staff are required to perform due diligence, that is, to verify and document that the funds of its private-banking customers were derived through legitimate means, and when extending credit, to verify that the use of loan proceeds was legitimate.
11. Review the institution's use of deposit accounts.
    a. Assess the adequacy of the institution's controls and whether they are appropriately used.
    b. Determine if client monies flow through client deposit accounts and whether the accounts function as the sole conduit and paper trail for client transactions.
12. Determine and ensure that each institution's approach to Suspicious Activity Reports (SARs) is proactive and that the bank holding company and each institution have well-established procedures covering the SAR process. Establish whether there is accountability within the organization for the analysis and follow-up of internally identified suspicious activity (this analysis includes a sound decision on whether the bank holding company or an institution needs to file, or is required by regulation to file, a SAR).

Banking organizations, including trust institutions, are increasingly encountering various direct or indirect financial incentives to place trust assets with particular mutual funds. Such incentives include the payment of fees to banking organizations for using nonaffiliated fund families as well as other incentives for using those mutual funds that are managed by the institution or an affiliate. The payment of such fees, referred to variously as shareholder, subaccounting, or administrative service fees, may be structured as payments to reimburse the institution for performing standard recordkeeping and accounting functions for the institution's fiduciary accounts. Those functions may consist of maintaining shareholder subaccounts and records, transmitting mutual fund communications as necessary, and arranging mutual fund transactions. These fees are typically based on a percentage or basis point amount of the dollar value of assets invested, or on transaction volume. Another form of compensation may consist of a lump-sum payment based on assets transferred into a mutual fund.

In all cases, decisions to place fiduciary assets in particular investments must be consistent with the underlying trust documents and must be undertaken in the best interests of the trust beneficiary. The primary supervisory concern is that an institution may fail to act in the best interest of beneficiaries if it stands to benefit independently from a particular investment. As a result, an institution may expose itself to an increased risk of legal action by account beneficiaries, as well as to potential violations of law or regulation.

In recent years, nearly every state legislature has modified its laws explicitly to allow fiduciaries to accept fees from mutual funds under certain conditions. As for the permissibility of other financial incentives, guidance under applicable law may be less clear. Conditions involving fee payments under state law often include compliance with standards of prudence, quality, and appropriateness for the account, and a determination of the "reasonableness" of the fees received by the institution. The Office of the Comptroller of the Currency (OCC) has also adopted these general standards for national banks.[1] The Employee Retirement Income Security Act of 1974 (ERISA), however, generally prohibits fee arrangements between fiduciaries and third parties, such as mutual fund providers, with limited exceptions.[2] ERISA requirements supersede state laws and guidelines put forth by the bank regulatory agencies.

Similar conflict-of-interest concerns are raised by the investment of fiduciary-account assets in mutual funds for which the institution or an affiliate acts as investment adviser (referred to as "proprietary" funds). In this case, the institution receives a financial benefit from management fees generated by the mutual fund investments. This activity can be expected to become more prevalent as banking organizations more actively offer proprietary mutual funds.[3] See SR-99-7.

2010.12.1 DUE-DILIGENCE REVIEW NEEDED BEFORE ENTERING INTO FEE ARRANGEMENTS

Although many state laws now explicitly authorize certain fee arrangements in conjunction with the investment of trust assets in mutual funds, institutions nonetheless face heightened legal and compliance risks from activities in which a conflict of interest exists, particularly if proper fiduciary standards are not observed and documented. Even when the institution does not exercise investment discretion, disclosure or other requirements may apply. Therefore, institutions should ensure that they perform and document an appropriate level of due diligence before entering into any fee arrangements similar to those described earlier or placing fiduciary assets in proprietary mutual funds. The following measures should be included in this process:

1. *Reasoned legal opinion.* The institution should obtain a reasoned opinion of counsel that addresses the conflict of interest inherent in the receipt of fees or other forms of com-

1. In general, national banks may make these investments and receive such fees if applicable law authorizes the practice and if the investment is prudent and appropriate for fiduciary accounts and consistent with established state law fiduciary requirements. This includes a "reasonableness" test for any fees received by the institution. See OCC Interpretive Letter No. 704, February 1996.

2. ERISA section 406(b)(3). See Department of Labor, Pension Welfare and Benefits Administration Advisory Opinion 97-15A and Advisory Opinion 97-16A.

3. A Board interpretation of Regulation Y addresses investment of fiduciary-account assets in mutual funds for which the trustee bank's holding company acts as investment adviser. In general, such investments are prohibited unless specifically authorized by the trust instrument, court order, or state law. See 12 C.F.R. 225.125.

pensation from mutual fund providers in connection with the investment of fiduciary assets. The opinion should address the permissibility of the investment and compensation under applicable state or federal laws, the trust instrument, or a court order, as well as any applicable disclosure requirements or reasonableness standard for fees set forth in the law.

2. *Establishment of policies and procedures.* The institution should establish written policies and procedures governing the acceptance of fees or other compensation from mutual fund providers as well as the use of proprietary mutual funds. The policies must be reviewed and approved by the institution's board of directors or its designated committee. Policies and procedures should, at a minimum, address the following issues: (1) designation of decision-making authority; (2) analysis and documentation of investment decisions; (3) compliance with applicable laws, regulations, and sound fiduciary principles, including any disclosure requirements or "reasonableness" standards for fees; and (4) staff training and methods for monitoring compliance with policies and procedures by internal or external audit staff.
3. *Analysis and documentation of investment decisions.* When fees or other compensation are received in connection with fiduciary-account investments over which the institution has investment discretion or when such investments are made in the institution's proprietary mutual funds, the institution should fully document its analysis supporting the investment decision. This analysis should be performed on a regular, ongoing basis and would typically include factors such as historical performance comparisons with similar mutual funds, management fees and expense ratios, and ratings by recognized mutual fund rating services. The institution should also document its assessment that the investment is, and continues to be, (1) appropriate for the individual account, (2) in the best interest of account beneficiaries, and (3) in compliance with the provisions of the "prudent investor" or "prudent man rules," as appropriate.

2010.12.2 INSPECTION OBJECTIVES

1. To determine that the institution has performed ongoing due-diligence reviews when it is receiving fees or other compensation for investing fiduciary assets in mutual funds or investing such assets in proprietary mutual funds.
2. To determine that the institution maintains full ongoing documentation of investment decisions and performance, and obtains legal opinions regarding its compliance with applicable laws and fiduciary standards, as well as potential conflicts of interest that may arise from its receiving fees or other compensation for investing fiduciary assets in mutual funds, including proprietary funds.

2010.12.3 INSPECTION PROCEDURES

1. Determine if a written legal opinion is on file that focuses on conflicts of interest that may arise from the receipt of fees and other compensation from mutual fund providers for investing fiduciary assets, and from the investment of these assets in proprietary mutual funds. Ascertain whether the legal opinion addresses the investment's permissibility, including its resulting compensation and any disclosure requirements under applicable state or federal laws, the trust instrument, or a court order.
2. Verify that the institution's board of directors has approved written policies and procedures governing the acceptance of fees and other compensation from mutual fund providers for placing investments with their firms and for the use of proprietary funds. Ascertain that the policies and procedures, at a minimum—
   a. determine what group or individual has decision-making authority;
   b. analyze and document supporting investment decisions;
   c. require compliance with applicable laws, regulations, and sound fiduciary principles, including disclosure requirements or reasonableness standards for fees; and
   d. address staff training and methods for monitoring compliance with policies and procedures by internal and external audit staff.
3. When fees and other compensation are being received in connection with fiduciary-account investments (those in which the institution has authorized discretionary investment authority) or when such assets are involved in proprietary mutual funds, ascertain whether there is full documentation of the institution's analysis supporting its

investment decisions on a regular, ongoing basis. Ascertain that the documentation includes—

a. historical performance comparisons with other mutual funds, engagement fees and expense ratios, and ratings by recognized mutual fund rating agencies;
b. an assessment that the investments are, and continue to be, appropriate for the individual account and in the best interests of its account beneficiaries; and
c. evidence of continued compliance with the provisions of the "prudent investor" or "prudent man rules."

On June 15, 2004, an interagency advisory concerning the embassy banking business and related banking matters was issued by the federal banking and thrift agencies[1] in coordination with the U.S. Department of the Treasury's Financial Crimes Enforcement Network. The purpose of the advisory is to provide general guidance to banking organizations regarding the treatment of accounts for foreign governments, foreign embassies, and foreign political figures.

The joint interagency statement advises banking organizations[2] that the decision to accept or reject an embassy or foreign government account is theirs alone to make. Financial institutions should be aware, however, that there are varying degrees of risk associated with such accounts, depending on the customer and the nature of the services provided. Financial institutions should take appropriate steps to manage such risks, consistent with sound practices and applicable anti-money-laundering laws and regulations. The advisory also encourages banking organizations to direct questions about embassy banking to their primary federal bank regulators. See SR-04-10.

2010.13.1 INTERAGENCY ADVISORY ON ACCEPTING ACCOUNTS FOR FOREIGN GOVERNMENTS, EMBASSIES, AND POLITICAL FIGURES

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

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

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

Institutions that have or are considering taking on relationships with foreign governments, embassies, or political figures should ensure that such customers are aware of the requirements of U.S. laws and regulations to which the institution is subject. Institutions should, to the maximum extent feasible, seek to structure such

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

2. The advisory is primarily directed to financial institutions located in the United States. The boards of directors of bank holding companies, however, should consider whether the advisory should be applied to their other U.S. subsidiaries' financial and other services.

relationships in order to conform them to conventional U.S. domestic banking relationships so as to reduce the risks that might be presented by such relationships.